

LAKELAND BANCORP INC  
Form 10-Q  
August 09, 2016  
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**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**(Mark one)**

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended June 30, 2016**

**OR**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 000-17820**

**LAKELAND BANCORP, INC.**

**(Exact name of registrant as specified in its charter)**

**New Jersey**  
**(State or other jurisdiction of**

**22-2953275**  
**(I.R.S. Employer**

**incorporation or organization)**

**Identification No.)**

**250 Oak Ridge Road, Oak Ridge, New Jersey**  
**(Address of principal executive offices)**

**07438**  
**(Zip Code)**

**(973) 697-2000**

**(Registrant's telephone number, including area code)**

**(Former name, former address and former fiscal year, if changed since last report.)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, any Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act: (Check one):

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Smaller reporting Company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.): Yes ☐ No ☒

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of July 29, 2016, there were 44,441,935 outstanding shares of Common Stock, no par value.



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The Securities and Exchange Commission maintains a web site which contains reports, proxy and information statements and other information relating to registrants that file electronically at the address: <http://www.sec.gov>.

**Table of Contents****Part I. FINANCIAL INFORMATION****Item 1. Financial Statements****Lakeland Bancorp, Inc. and Subsidiaries****CONSOLIDATED BALANCE SHEETS**

|   | June 30, 2016<br>(unaudited) | December 31,<br>2015 |
|---|------------------------------|----------------------|
| (dollars in thousands, except share amounts)  |                              |                      |
| <b>ASSETS</b>   |                              |                      |
| Cash  | \$ 146,306                   | \$ 113,894           |
| Interest-bearing deposits due from banks  | 6,577                        | 4,599                |
| Total cash and cash equivalents   | 152,883                      | 118,493              |
| Investment securities available for sale, at fair value   | 460,390                      | 442,349              |
| Investment securities held to maturity; fair value of \$129,447 at June 30, 2016 and \$117,594 at December 31, 2015 | 126,221                      | 116,740              |
| Federal Home Loan Bank and other membership bank stock, at cost   | 15,797                       | 14,087               |
| Loans held for sale   | 6,463                        | 1,233                |
| Loans, net of deferred costs (fees)   | 3,451,382                    | 2,965,200            |
| Less: allowance for loan and lease losses   | 30,667                       | 30,874               |
| Net loans   | 3,420,715                    | 2,934,326            |
| Premises and equipment, net   | 49,322                       | 35,881               |
| Accrued interest receivable   | 10,480                       | 9,208                |
| Goodwill  | 125,285                      | 109,974              |
| Other identifiable intangible assets  | 2,728                        | 1,545                |
| Bank owned life insurance   | 66,212                       | 65,361               |
| Other assets  | 31,364                       | 20,353               |
| <b>TOTAL ASSETS</b>   | <b>\$ 4,467,860</b>          | <b>\$ 3,869,550</b>  |
| <b>LIABILITIES</b>  |                              |                      |
| Deposits:   |                              |                      |
| Noninterest bearing   | \$ 824,077                   | \$ 693,741           |
| Savings and interest-bearing transaction accounts   | 2,235,918                    | 1,958,510            |
| Time deposits \$250 thousand and under  | 359,471                      | 270,623              |
| Time deposits over \$250 thousand   | 117,865                      | 72,698               |
| Total deposits  | 3,537,331                    | 2,995,572            |
| Federal funds purchased and securities sold under agreements to repurchase  | 123,662                      | 151,234              |

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|                         |         |         |
|-------------------------|---------|---------|
| Other borrowings        | 294,771 | 271,905 |
| Subordinated debentures | 31,238  | 31,238  |
| Other liabilities       | 25,924  | 19,085  |

|                   |           |           |
|-------------------|-----------|-----------|
| TOTAL LIABILITIES | 4,012,926 | 3,469,034 |
|-------------------|-----------|-----------|

**STOCKHOLDERS EQUITY**

Common stock, no par value; authorized shares, 70,000,000; issued

41,240,826 shares at June 30, 2016 and 37,906,481 shares at

|                   |         |         |
|-------------------|---------|---------|
| December 31, 2015 | 424,409 | 386,287 |
|-------------------|---------|---------|

|                   |        |        |
|-------------------|--------|--------|
| Retained earnings | 23,836 | 13,079 |
|-------------------|--------|--------|

|  |       |       |
|--|-------|-------|
| Accumulated other comprehensive income | 6,689 | 1,150 |
|--|-------|-------|

|                           |         |         |
|---------------------------|---------|---------|
| TOTAL STOCKHOLDERS EQUITY | 454,934 | 400,516 |
|---------------------------|---------|---------|

|   |              |              |
|---|--------------|--------------|
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 4,467,860 | \$ 3,869,550 |
|---|--------------|--------------|

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****Lakeland Bancorp, Inc. and Subsidiaries****CONSOLIDATED STATEMENTS OF INCOME - UNAUDITED**

For the Three Months Ended June 30, 2016  
 For the Three Months Ended June 30, 2015  
 For the Six Months Ended June 30, 2016  
 For the Six Months Ended June 30, 2015  
 (in thousands, except per share data)

**INTEREST INCOME**

|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Loans, leases and fees                                      | \$ 35,800 | \$ 28,211 | \$ 69,921 | \$ 56,107 |
| Federal funds sold and interest-bearing deposits with banks | 124       | 11        | 199       | 23        |
| Taxable investment securities and other                     | 2,696     | 2,688     | 5,658     | 5,362     |
| Tax-exempt investment securities                            | 417       | 398       | 830       | 808       |

|                              |               |               |               |               |
|------------------------------|---------------|---------------|---------------|---------------|
| <b>TOTAL INTEREST INCOME</b> | <b>39,037</b> | <b>31,308</b> | <b>76,608</b> | <b>62,300</b> |
|------------------------------|---------------|---------------|---------------|---------------|

**INTEREST EXPENSE**

|  |       |       |       |       |
|--|-------|-------|-------|-------|
| Deposits   | 2,404 | 1,346 | 4,609 | 2,629 |
| Federal funds purchased and securities sold under agreements to repurchase | 9     | 37    | 47    | 59    |
| Other borrowings   | 1,522 | 1,256 | 3,000 | 2,425 |

|                               |              |              |              |              |
|-------------------------------|--------------|--------------|--------------|--------------|
| <b>TOTAL INTEREST EXPENSE</b> | <b>3,935</b> | <b>2,639</b> | <b>7,656</b> | <b>5,113</b> |
|-------------------------------|--------------|--------------|--------------|--------------|

|                            |               |               |               |               |
|----------------------------|---------------|---------------|---------------|---------------|
| <b>NET INTEREST INCOME</b> | <b>35,102</b> | <b>28,669</b> | <b>68,952</b> | <b>57,187</b> |
|----------------------------|---------------|---------------|---------------|---------------|

|                                     |       |     |       |       |
|-------------------------------------|-------|-----|-------|-------|
| Provision for loan and lease losses | 1,010 | 740 | 2,085 | 1,610 |
|-------------------------------------|-------|-----|-------|-------|

|  |               |               |               |               |
|--|---------------|---------------|---------------|---------------|
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES</b> | <b>34,092</b> | <b>27,929</b> | <b>66,867</b> | <b>55,577</b> |
|--|---------------|---------------|---------------|---------------|

**NONINTEREST INCOME**

|   |       |       |       |       |
|---|-------|-------|-------|-------|
| Service charges on deposit accounts     | 2,523 | 2,450 | 4,965 | 4,790 |
| Commissions and fees                    | 1,099 | 1,196 | 2,078 | 2,503 |
| Gains on sales of investment securities |       | 17    | 370   | 17    |
| Gains on sales of loans                 | 425   | 464   | 845   | 729   |
| Income on bank owned life insurance     | 414   | 388   | 822   | 1,087 |
| Other income                            | 424   | 443   | 672   | 570   |

|                                 |              |              |              |              |
|---------------------------------|--------------|--------------|--------------|--------------|
| <b>TOTAL NONINTEREST INCOME</b> | <b>4,885</b> | <b>4,958</b> | <b>9,752</b> | <b>9,696</b> |
|---------------------------------|--------------|--------------|--------------|--------------|

**NONINTEREST EXPENSE**

|                                  |        |        |        |        |
|----------------------------------|--------|--------|--------|--------|
| Salaries and employee benefits   | 13,091 | 12,144 | 27,176 | 23,894 |
| Net occupancy expense            | 2,341  | 2,273  | 5,029  | 4,821  |
| Furniture and equipment          | 2,082  | 1,629  | 4,028  | 3,285  |
| Stationery, supplies and postage | 416    | 377    | 859    | 742    |
| Marketing expense                | 385    | 416    | 694    | 656    |
| FDIC insurance expense           | 681    | 531    | 1,271  | 1,049  |
| Data processing expense          | 459    | 438    | 979    | 773    |

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|  |                  |                 |                  |                  |
|--|------------------|-----------------|------------------|------------------|
| Telecommunications expense                                       | 386              | 358             | 810              | 703              |
| ATM and debit card expense                                       | 383              | 382             | 729              | 724              |
| Expenses on other real estate owned and other repossessed assets | 26               | 27              | 65               | 19               |
| Merger related expenses  | 685              |                 | 2,406            |                  |
| Core deposit intangible amortization                             | 164              | 107             | 331              | 218              |
| Other expenses   | 2,616            | 2,513           | 4,762            | 4,353            |
| <b>TOTAL NONINTEREST EXPENSE</b>                                 | <b>23,715</b>    | <b>21,195</b>   | <b>49,139</b>    | <b>41,237</b>    |
| Income before provision for income taxes                         | 15,262           | 11,692          | 27,480           | 24,036           |
| Income tax expense   | 5,132            | 3,830           | 9,242            | 7,844            |
| <b>NET INCOME</b>  | <b>\$ 10,130</b> | <b>\$ 7,862</b> | <b>\$ 18,238</b> | <b>\$ 16,192</b> |
| <b>PER SHARE OF COMMON STOCK</b>                                 |                  |                 |                  |                  |
| Basic earnings   | \$ 0.24          | \$ 0.21         | \$ 0.44          | \$ 0.42          |
| Diluted earnings   | \$ 0.24          | \$ 0.21         | \$ 0.44          | \$ 0.42          |
| Dividends  | \$ 0.095         | \$ 0.085        | \$ 0.180         | \$ 0.160         |

The accompanying notes are an integral part of these consolidated financial statements.



**Table of Contents****Lakeland Bancorp, Inc. and Subsidiaries****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME - UNAUDITED**

|  | For the Three Months Ended June 30, |          | For the Six Months Ended June 30, |           |
|--|-------------------------------------|----------|-----------------------------------|-----------|
|  | 2016                                | 2015     | 2016                              | 2015      |
|  | (in thousands)                      |          |                                   |           |
| NET INCOME   | \$ 10,130                           | \$ 7,862 | \$ 18,238                         | \$ 16,192 |
| OTHER COMPREHENSIVE INCOME, NET OF TAX:            |                                     |          |                                   |           |
| Unrealized securities gains (losses) during period | 1,697                               | (2,177)  | 5,854                             | 498       |
| Reclassification for gains included in net income  |                                     | (17)     | (233)                             | (17)      |
| Unrealized losses on derivatives                   | (126)                               |          | (126)                             |           |
| Change in pension liability, net                   | 6                                   | 5        | 44                                | 10        |
| Other comprehensive income (loss)                  | 1,577                               | (2,189)  | 5,539                             | 491       |
| TOTAL COMPREHENSIVE INCOME                         | \$ 11,707                           | \$ 5,673 | \$ 23,777                         | \$ 16,683 |

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****Lakeland Bancorp, Inc. and Subsidiaries****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY - UNAUDITED**

|   | For the Six Months Ended June 30, 2016          |                      |                |            |
|---|---|----------------------|----------------|------------|
|   | Accumulated<br>Other<br>Comprehensive<br>Income |                      |                | Total      |
|   | Common<br>Stock                                 | Retained<br>Earnings | (in thousands) |            |
| At January 1, 2016                        | \$ 386,287                                      | \$ 13,079            | \$ 1,150       | \$ 400,516 |
| Net Income                                |   | 18,238               |                | 18,238     |
| Other comprehensive income, net of tax    |   |                      | 5,539          | 5,539      |
| Stock based compensation                  | 1,107   |                      |                | 1,107      |
| Issuance of stock for Pascack acquisition | 37,221  |                      |                | 37,221     |
| Retirement of restricted stock            | (206)   |                      |                | (206)      |
| Cash dividends, common stock              |   | (7,481)              |                | (7,481)    |
| At June 30, 2016                          | \$ 424,409                                      | \$ 23,836            | \$ 6,689       | \$ 454,934 |

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****Lakeland Bancorp, Inc. and Subsidiaries****CONSOLIDATED STATEMENTS OF CASH FLOWS - UNAUDITED**

|   | For the Six Months Ended June 30, |                  |
|---|-----------------------------------|------------------|
|   | 2016                              | 2015             |
|   | (in thousands)                    |                  |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                                   |                  |
| Net income  | \$ 18,238                         | \$ 16,192        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |                  |
| Net amortization of premiums, discounts and deferred loan fees and costs          | 1,794                             | 2,009            |
| Depreciation and amortization   | 1,847                             | 1,914            |
| Amortization of intangible assets   | 331                               | 218              |
| Provision for loan and lease losses   | 2,085                             | 1,610            |
| Loans originated for sale   | (38,408)                          | (34,649)         |
| Proceeds from sales of loans  | 34,023                            | 32,622           |
| Gains on sales of securities  | (370)                             | (17)             |
| Gains on sales of loans held for sale   | (845)                             | (729)            |
| Gains on other real estate and other repossessed assets                           | (90)                              | (144)            |
| Losses on sales of premises and equipment   | 117                               | 2                |
| Stock-based compensation  | 1,107                             | 912              |
| Increase in other assets  | (9,176)                           | (3,535)          |
| Increase (decrease) in other liabilities  | 483                               | (281)            |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                  | <b>11,136</b>                     | <b>16,124</b>    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                                   |                  |
| Net cash acquired in acquisition  | 40,942                            |                  |
| Proceeds from repayments on and maturity of securities:                           |                                   |                  |
| Available for sale  | 40,083                            | 37,946           |
| Held to maturity  | 13,156                            | 8,804            |
| Proceeds from sales of securities   |                                   |                  |
| Available for sale  | 15,654                            | 11,472           |
| Purchase of securities:   |                                   |                  |
| Available for sale  | (61,705)                          | (54,241)         |
| Held to maturity  | (22,778)                          | (24,245)         |
| Purchase of bank owned life insurance   |                                   | (4,078)          |
| Proceeds from bank owned life insurance policy                                    |                                   | 772              |
| Net decrease (increase) in Federal Home Loan Bank Stock                           | 1,253                             | (2,933)          |
| Net increase in loans and leases  | (170,698)                         | (103,750)        |
| Proceeds from sales of other real estate and repossessed assets                   | 758                               | 853              |
| Proceeds from dispositions and sales of premises and equipment                    | 11                                | 4                |
| Capital expenditures  | (1,648)                           | (2,053)          |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>                                      | <b>(144,972)</b>                  | <b>(131,449)</b> |

**CASH FLOWS FROM FINANCING ACTIVITIES**

|   |          |          |
|---|----------|----------|
| Net increase in deposits  | 237,564  | 52,204   |
| (Decrease) increase in federal funds purchased and securities sold under agreements to repurchase | (27,572) | 37,314   |
| Proceeds from other borrowings  | 4,921    | 70,230   |
| Repayments of other borrowings  | (39,000) | (10,000) |
| Excess tax benefits   |          | 59       |
| Exercise of stock options   |          | 113      |
| Retirement of restricted stock  | (206)    | (250)    |
| Dividends paid  | (7,481)  | (6,095)  |

**NET CASH PROVIDED BY FINANCING ACTIVITIES** 168,226 143,575

|  |         |         |
|--|---------|---------|
| Net increase in cash and cash equivalents      | 34,390  | 28,250  |
| Cash and cash equivalents, beginning of period | 118,493 | 109,316 |

**CASH AND CASH EQUIVALENTS, END OF PERIOD** \$ 152,883 \$ 137,566

The accompanying notes are an integral part of these consolidated financial statements.

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**Notes to Consolidated Financial Statements    Unaudited**

**Note 1. Significant Accounting Policies**

*Basis of Presentation.*

This quarterly report presents the consolidated financial statements of Lakeland Bancorp, Inc. and its subsidiaries, including Lakeland Bank (Lakeland) and the Bank's wholly owned subsidiaries (collectively, the Company). The accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America (U.S. GAAP) and predominant practices within the banking industry.

The Company's unaudited interim financial statements reflect all adjustments, such as normal recurring accruals that are, in the opinion of management, necessary for the fair presentation of the results of the interim periods. The results of operations for the three and six months ended June 30, 2016 do not necessarily indicate the results that the Company will achieve for all of 2016.

Certain information and footnote disclosures required under U.S. GAAP have been condensed or omitted, as permitted by rules and regulations of the Securities and Exchange Commission. You should read these interim financial statements in conjunction with the audited consolidated financial statements and accompanying notes that are presented in the Lakeland Bancorp, Inc. Annual Report on Form 10-K for the year ended December 31, 2015.

**Note 2. Acquisitions**

*Harmony Bank*

On July 1, 2016, the Company completed its acquisition of Harmony Bank, a bank located in Ocean County, NJ. Effective upon the opening of business on July 1, 2016, Harmony was merged into Lakeland Bank. This merger allows the Company to expand its presence to Ocean County. The merger agreement provided that shareholders of Harmony would receive 1.25 shares of the Company common stock for each share of Harmony Bank common stock that they owned at the effective time of the merger. The Company issued an aggregate of approximately 3,201,109 shares of its common stock in the merger. Outstanding Harmony stock options were paid out in cash at the difference between \$14.31 (Lakeland's closing stock price on July 1, 2016 of \$11.45 multiplied by 1.25) and the average strike price of \$9.07 for a total cash payment of \$869,000. As of the opening of business July 1, 2016, Harmony operated three branches in Ocean County, New Jersey, and had total assets, total loans, total deposits and total stockholders equity of \$314 million, \$261 million, \$277 million, and \$24 million, respectively. As the merger has not been completed as of June 30, 2016, the transaction is not reflected in the balance sheet or results of operations for the periods presented in this document.

*Pascack Bancorp*

On January 7, 2016, the Company completed its acquisition of Pascack Bancorp, Inc. (Pascack), a bank holding company headquartered in Waldwick, New Jersey. Pascack was the parent of Pascack Community Bank. This acquisition enables the Company to broaden its presence in Bergen and Essex counties. Effective as of the close of business on January 7, 2016, Pascack merged into the Company, and Pascack Community Bank merged into Lakeland Bank. The Merger Agreement provided that the shareholders of Pascack would receive, at their election, for each outstanding share of Pascack common stock that they own at the effective time of the merger, either 0.9576 shares of Lakeland Bancorp common stock or \$11.35 in cash, subject to proration as described in the Merger Agreement, so that 90% of the aggregate merger consideration was shares of Lakeland Bancorp common stock and 10% was cash.

Lakeland Bancorp issued an aggregate of 3,314,284 shares of its common stock in the merger and paid approximately \$4.4 million in cash excluding the cash paid in connection with the cancellation of Pascack stock options. Outstanding Pascack stock options were paid out in cash at the difference between \$11.35 and an average strike price of \$7.37 for a total cash payment of \$122,000. As of January 7, 2016, Pascack operated 8 branches in Bergen and Essex Counties in New Jersey, and had total assets, total loans, total deposits and total stockholders' equity of \$389.9 million, \$320.9 million, \$303.2 million and \$26.9 million, respectively, before purchase accounting adjustments. This transaction resulted in \$15.3 million of goodwill and generated \$1.5 million in core deposit intangibles.

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During the quarter ended June 30, 2016, the Company revised the estimated fair value of the acquired assets as of the acquisition date as the result of additional information obtained. The adjustment related to the fair market value of certain fixed assets which resulted in a \$158,000 decrease in goodwill.

The acquisition was accounted for under the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at their estimated fair values as of the acquisition date. Pascack's assets were recorded at their preliminary estimated fair values as of January 7, 2016 and Pascack's results of operations are included in the Company's Consolidated Statements of Income from that date forward.

The assets acquired and liabilities assumed in the acquisition were recorded at their estimated fair values based on management's best estimates using information available at the date of the acquisition, including the use of a third party valuation specialist. The fair values are preliminary estimates and subject to adjustment for up to one year after the closing date of the acquisition. The following table summarizes the estimated fair value of the acquired assets and liabilities assumed at the date of acquisition for Pascack, net of cash consideration paid.

|  | On January 7,<br>2016<br>(in thousands) |
|--|---|
| Cash and cash equivalents                    | \$ 40,942                               |
| Securities held to maturity                  | 3,925                                   |
| Federal Home Loan Bank stock                 | 2,962                                   |
| Loans and leases                             | 319,575                                 |
| Premises and equipment                       | 14,438                                  |
| Goodwill                                     | 15,311                                  |
| Identifiable intangible assets               | 1,514                                   |
| Accrued interest receivable and other assets | 6,672                                   |
| <b>Total assets acquired</b>                 | <b>405,339</b>                          |
| Deposits                                     | (304,466)                               |
| Other borrowings                             | (57,308)                                |
| Other liabilities                            | (6,344)                                 |
| <b>Total liabilities assumed</b>             | <b>(368,118)</b>                        |
| <b>Net assets acquired</b>                   | <b>\$ 37,221</b>                        |

Loans acquired in the Pascack acquisition were recorded at fair value and subsequently accounted for in accordance with ASC Topic 310, and there was no carryover related allowance for loan and lease losses. The fair values of loans acquired from Pascack were estimated using cash flow projections based on the remaining maturity and repricing terms. Cash flows were adjusted for estimated future credit losses and the rate of prepayments. Projected cash flows were then discounted to present value using a risk-adjusted market rate for similar loans.

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The following is a summary of the loans acquired in the Pascack acquisition as of the closing date.

| (in thousands)  | Acquired<br>Credit<br>Impaired<br>Loans | Acquired<br>Non-Credit<br>Impaired<br>Loans | Total<br>Acquired<br>Loans |
|---|---|---|----------------------------|
| Contractually required principal and interest at acquisition                    | \$ 4,932                                | \$ 442,401                                  | \$ 447,333                 |
| Contractual cash flows not expected to be collected (non-accretable difference) | 4,030                                   |   | 4,030                      |
| Expected cash flows at acquisition  | \$ 902                                  | \$ 442,401                                  | \$ 443,303                 |
| Interest component of expected cash flows (accretable difference)               | 85                                      | 123,643                                     | 123,728                    |
| Fair value of acquired loans  | \$ 817                                  | \$ 318,758                                  | \$ 319,575                 |

The core deposit intangible totaled \$1.5 million and is being estimated over its estimated useful life of approximately 10 years using an accelerated method. The goodwill will be evaluated annually for impairment. The goodwill is not deductible for tax purposes.

The fair values of deposit liabilities with no stated maturities such as checking, money market and savings accounts, were assumed to equal the carrying amounts since these deposits are payable on demand. The fair values of certificates of deposits and IRAs represent the present value of contractual cash flows discounted at market rates for similar certificates of deposit.

Direct costs related to the Pascack and Harmony acquisitions were expensed as incurred. During the six months ended June 30, 2016, the Company incurred \$2.4 million of merger and acquisition integration-related expenses, which have been separately stated in the Company's consolidated statements of income.

**Supplemental Pro Forma Financial Information**

The following table provides unaudited condensed pro forma financial information assuming that the Pascack acquisition had been completed as of January 1, 2016, for the six months ended June 30, 2016 and as of January 1, 2015 for the six months ended June 30, 2015. The table below has been prepared for comparative purposes only and is not necessarily indicative of the actual results that would have been attained had the acquisition occurred as of the beginning of the periods presented, nor is it indicative of future results. Furthermore, the unaudited proforma information does not reflect management's estimate of any revenue-enhancing opportunities nor anticipated cost savings or the impact of conforming certain accounting policies of the acquired company to the Company's policies that may have occurred as a result of the integration and consolidation of Pascack's operations. The pro forma information shown reflects adjustments related to certain purchase accounting fair value adjustments; amortization of core deposit and other intangibles; and related income tax effects. The Company has not provided separate information regarding revenue and earnings of Pascack since the acquisition because of the manner in which Pascack's branches and lending team were immediately merged into Lakeland's branches and lending team making such information impracticable to provide.





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| (in thousands)            | Pro-Forma<br>June 30, 2016 | Pro-Forma<br>June 30, 2015 |
|---------------------------|----------------------------|----------------------------|
| Net interest income       | \$ 69,209                  | \$ 64,518                  |
| Provision for loan losses | 2,085                      | 1,610                      |
| Noninterest income        | 9,756                      | 9,887                      |
| Noninterest expense       | 46,978                     | 46,506                     |
| Net income                | 19,855                     | 17,528                     |
| Earnings per share:       |                            |                            |
| Fully diluted             | \$ 0.48                    | \$ 0.42                    |

**Note 3. Earnings Per Share**

The following schedule shows the Company's earnings per share calculations for the periods presented:

| (In thousands, except per share data)                          | For the Three Months Ended June 30, and Six Months Ended June 30, |          |           |           |
|--|---|----------|-----------|-----------|
|  | 2016  | 2015     | 2016      | 2015      |
| Net income available to common shareholders                    | \$ 10,130   | \$ 7,862 | \$ 18,238 | \$ 16,192 |
| Less: earnings allocated to participating securities           | 106   | 68       | 162       | 120       |
| Net income allocated to common shareholders                    | \$ 10,024   | \$ 7,794 | \$ 18,076 | \$ 16,072 |
| Weighted average number of common shares outstanding - basic   | 41,238  | 37,854   | 41,084    | 37,827    |
| Share-based plans  | 168   | 134      | 161       | 134       |
| Weighted average number of common shares outstanding - diluted | 41,406  | 37,988   | 41,245    | 37,961    |
| Basic earnings per share                                       | \$ 0.24   | \$ 0.21  | \$ 0.44   | \$ 0.42   |
| Diluted earnings per share                                     | \$ 0.24   | \$ 0.21  | \$ 0.44   | \$ 0.42   |

There were no antidilutive options to purchase common stock to be excluded from the computation for the three and six months ended June 30, 2016.

Options to purchase 83,437 shares of common stock at a weighted average price of \$12.29 per share were outstanding and were not included in the computations of diluted earnings per share for the three and six months ended June 30, 2015 because the exercise price was greater than the average market price.

**Table of Contents****Note 4. Investment Securities**

| Available For Sale                                     | June 30, 2016     |  |   |               | December 31, 2015 |  |   |               |
|--|-------------------|--|---|---------------|-------------------|--|---|---------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains<br>(in thousands) | Gross<br>Unrealized<br>Losses<br>(in thousands) | Fair<br>Value | Amortized<br>Cost | Gross<br>Unrealized<br>Gains<br>(in thousands) | Gross<br>Unrealized<br>Losses<br>(in thousands) | Fair<br>Value |
| U.S. treasury and U.S.<br>government agencies          | \$ 90,746         | \$ 2,034                                       | \$  | \$ 92,780     | \$ 97,617         | \$ 190   | \$ (674)  | \$ 97,133     |
| Mortgage-backed<br>securities, residential             | 292,829           | 4,835  | (119)   | 297,545       | 280,018           | 1,717  | (2,283)   | 279,452       |
| Mortgage-backed<br>securities, multifamily             | 10,220            | 288  |   | 10,508        | 10,249            |  | (129)   | 10,120        |
| Obligations of states<br>and political<br>subdivisions | 39,225            | 1,390  | (8)   | 40,607        | 35,639            | 910  | (51)  | 36,498        |
| Other debt securities                                  |                   |  |   |               | 498               | 3  |   | 501           |
| Equity securities                                      | 16,715            | 2,490  | (255)   | 18,950        | 16,550            | 2,393  | (298)   | 18,645        |
|  | \$ 449,735        | \$ 11,037                                      | \$ (382)  | \$ 460,390    | \$ 440,571        | \$ 5,213                                       | \$ (3,435)                                      | \$ 442,349    |

| Held to Maturity                                       | June 30, 2016     |  |   |               | December 31, 2015 |  |   |               |
|--|-------------------|--|---|---------------|-------------------|--|---|---------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains<br>(in thousands) | Gross<br>Unrealized<br>Losses<br>(in thousands) | Fair<br>Value | Amortized<br>Cost | Gross<br>Unrealized<br>Gains<br>(in thousands) | Gross<br>Unrealized<br>Losses<br>(in thousands) | Fair<br>Value |
| U.S. government<br>agencies                            | \$ 26,589         | \$ 974   | \$  | \$ 27,563     | \$ 30,477         | \$ 289   | \$ (94)   | \$ 30,672     |
| Mortgage-backed<br>securities, residential             | 37,972            | 882  | (33)  | 38,821        | 36,466            | 411  | (426)   | 36,451        |
| Mortgage-backed<br>securities, multifamily             | 2,110             | 23   |   | 2,133         | 2,159             |  | (60)  | 2,099         |
| Obligations of states<br>and political<br>subdivisions | 57,534            | 1,370  | (62)  | 58,842        | 45,617            | 809  | (156)   | 46,270        |
| Other debt securities                                  | 2,016             | 72   |   | 2,088         | 2,021             | 81   |   | 2,102         |
|  | \$ 126,221        | \$ 3,321                                       | \$ (95)   | \$ 129,447    | \$ 116,740        | \$ 1,590                                       | \$ (736)  | \$ 117,594    |

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The following table shows investment securities by stated maturity. Securities backed by mortgages have expected maturities that differ from contractual maturities because borrowers have the right to call or prepay, and are, therefore, classified separately with no specific maturity date (in thousands):

|  | June 30, 2016                           |               |                                       |               |
|--|---|---------------|---------------------------------------|---------------|
|  | Available for Sale<br>Amortized<br>Cost | Fair<br>Value | Held to Maturity<br>Amortized<br>Cost | Fair<br>Value |
| Due in one year or less                | \$ 2,389                                | \$ 2,405      | \$ 20,956                             | \$ 20,924     |
| Due after one year through five years  | 73,837                                  | 75,555        | 23,854                                | 24,629        |
| Due after five years through ten years | 48,059                                  | 49,516        | 34,112                                | 35,442        |
| Due after ten years                    | 5,686                                   | 5,911         | 7,217                                 | 7,498         |
|  | 129,971                                 | 133,387       | 86,139                                | 88,493        |
| Mortgage-backed securities             | 303,049                                 | 308,053       | 40,082                                | 40,954        |
| Equity securities                      | 16,715                                  | 18,950        |                                       |               |
| Total securities                       | \$ 449,735                              | \$ 460,390    | \$ 126,221                            | \$ 129,447    |

The following table shows proceeds from sales of securities and gross gains on sales of securities for the periods indicated (in thousands):

|               | For the Three Months Ended<br>June 30, |           | For the Six Months Ended<br>June 30, |           |
|---------------|--|-----------|--------------------------------------|-----------|
|               | 2016                                   | 2015      | 2016                                 | 2015      |
| Sale proceeds | \$                                     | \$ 11,472 | \$ 15,654                            | \$ 11,472 |
| Gross gains   |  | 28        | 370                                  | 28        |
| Gross losses  |  | (11)      |                                      | (11)      |

There were no other-than-temporary impairments for the six months ended June 30, 2016 or 2015.

Gains or losses on sales of investment securities are based on the net proceeds and the adjusted carrying amount of the securities sold using the specific identification method.

Securities with a carrying value of approximately \$357.0 million and \$347.7 million at June 30, 2016 and December 31, 2015, respectively, were pledged to secure public deposits and for other purposes required by applicable laws and regulations.

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The following table indicates the length of time individual securities have been in a continuous unrealized loss position at June 30, 2016 and December 31, 2015:

| June 30, 2016                                       | Less than 12 months |                      | 12 months or longer |                      | Number<br>of<br>Securities | Total         |                      |
|---|---------------------|----------------------|---------------------|----------------------|----------------------------|---------------|----------------------|
|   | Fair Value          | Unrealized<br>Losses | Fair Value          | Unrealized<br>Losses |                            | Fair Value    | Unrealized<br>Losses |
| (in thousands)                                      |                     |                      |                     |                      |                            |               |                      |
| Available for Sale                                  |                     |                      |                     |                      |                            |               |                      |
| Mortgage-backed securities,<br>residential          | \$ 5,089            | \$ 22                | \$ 16,727           | \$ 97                | 14                         | \$ 21,816     | \$ 119               |
| Obligations of states and political<br>subdivisions | 888                 | 8                    |                     |                      | 1                          | 888           | 8                    |
| Equity securities                                   | 234                 | 42                   | 4,774               | 213                  | 2                          | 5,008         | 255                  |
|   | \$ 6,211            | \$ 72                | \$ 21,501           | \$ 310               | 17                         | \$ 27,712     | \$ 382               |
| Held to Maturity                                    |                     |                      |                     |                      |                            |               |                      |
| Mortgage-backed securities,<br>residential          | \$ 2,291            | \$ 10                | \$ 1,121            | \$ 23                | 3                          | \$ 3,412      | \$ 33                |
| Obligations of states and political<br>subdivisions | 15,204              | 61                   | 752                 | 1                    | 13                         | 15,956        | 62                   |
|   | \$ 17,495           | \$ 71                | \$ 1,873            | \$ 24                | 16                         | \$ 19,368     | \$ 95                |
| December 31, 2015                                   | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value       | Unrealized<br>Losses | Number of<br>Securities    | Fair<br>Value | Unrealized<br>Losses |
| (in thousands)                                      |                     |                      |                     |                      |                            |               |                      |
| Available for Sale                                  |                     |                      |                     |                      |                            |               |                      |
| U.S. treasury and U.S. government<br>agencies       | \$ 80,192           | \$ 674               | \$                  | \$                   | 16                         | \$ 80,192     | \$ 674               |
| Mortgage-backed securities,<br>residential          | 103,749             | 1,043                | 50,095              | 1,240                | 50                         | 153,844       | 2,283                |
| Mortgage-backed securities,<br>multifamily          | 10,120              | 129                  |                     |                      | 2                          | 10,120        | 129                  |
| Obligations of states and political<br>subdivisions | 2,051               | 4                    | 1,466               | 47                   | 7                          | 3,517         | 51                   |
| Other debt securities                               |                     |                      |                     |                      |                            |               |                      |
| Equity securities                                   | 247                 | 24                   | 4,643               | 274                  | 3                          | 4,890         | 298                  |
|   | \$ 196,359          | \$ 1,874             | \$ 56,204           | \$ 1,561             | 78                         | \$ 252,563    | \$ 3,435             |

| Held to Maturity                                 |           |        |          |        |    |           |        |
|--|-----------|--------|----------|--------|----|-----------|--------|
| U.S. government agencies                         | \$ 15,683 | \$ 94  | \$       | \$     | 3  | \$ 15,683 | \$ 94  |
| Mortgage-backed securities, residential          | 20,283    | 262    | 6,687    | 164    | 11 | 26,970    | 426    |
| Mortgage-backed securities, multifamily          | 1,223     | 18     | 876      | 42     | 2  | 2,099     | 60     |
| Obligations of states and political subdivisions | 9,181     | 149    | 2,043    | 7      | 15 | 11,224    | 156    |
|  | \$ 46,370 | \$ 523 | \$ 9,606 | \$ 213 | 31 | \$ 55,976 | \$ 736 |

Management has evaluated the securities in the above table and has concluded that none of the securities are other-than-temporarily impaired. The cause of the fair values being below cost is due to interest rate movements and is deemed temporary. All investment securities are evaluated on a periodic basis to identify any factors that would require a further analysis. In evaluating the Company's securities, management considers the following items:

The Company's ability and intent to hold the securities, including an evaluation of the need to sell the security to meet certain liquidity measures, or whether the Company has sufficient levels of cash to hold the identified security in order to recover the entire amortized cost of the security;

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The financial condition of the underlying issuer;

The credit ratings of the underlying issuer and if any changes in the credit rating have occurred;

The length of time the security's fair value has been less than amortized cost; and

Adverse conditions related to the security or its issuer if the issuer has failed to make scheduled payments or other factors.

If the above factors indicate that an additional analysis is required, management will perform and consider the results of a discounted cash flow analysis.

As of June 30, 2016, the equity securities include investments in equity stocks and investments in investment funds that use net asset value per share to measure fair value. The equity stocks represent investments in other financial institutions for market appreciation purposes. Those equities had a purchase price of \$2.7 million and a market value of \$5.0 million as of June 30, 2016.

The investment funds include \$2.9 million that are primarily invested in community development loans that are guaranteed by the Small Business Administration (SBA). Because the funds are primarily guaranteed by the federal government there are minimal changes in market value between accounting periods. These funds can be redeemed with 60 days notice at the net asset value less unpaid management fees with the approval of the fund manager. As of June 30, 2016, the net amortized cost equaled the market value of the investment. There are no unfunded commitments related to this investment.

The investment funds also include \$11.0 million that are invested in government guaranteed loans, mortgage-backed securities, small business loans and other instruments supporting affordable housing and economic development. The Company may redeem these funds at the net asset value calculated at the end of the current business day less any unpaid management fees. As of June 30, 2016, the amortized cost of these securities was \$11.0 million and the fair value was \$11.0 million. There are no restrictions on redemptions for the holdings in these investments other than the notice required by the fund manager. There are no unfunded commitments related to this investment.

**Note 5. Loans, Leases and Other Real Estate**

The following sets forth the composition of the Company's loan and lease portfolio as of June 30, 2016 and December 31, 2015:

|                                    | June 30,<br>2016 | December 31,<br>2015 |
|------------------------------------|------------------|----------------------|
|                                    | (in thousands)   |                      |
| Commercial, secured by real estate | \$ 2,200,147     | \$ 1,761,589         |
| Commercial, industrial and other   | 313,062          | 307,044              |
| Leases                             | 63,338           | 56,660               |
| Real estate - residential mortgage | 383,823          | 389,692              |
| Real estate - construction         | 152,978          | 118,070              |

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|                             |              |              |
|-----------------------------|--------------|--------------|
| Home equity and consumer    | 340,956      | 334,891      |
| Total loans                 | 3,454,304    | 2,967,946    |
| Less: deferred fees         | (2,922)      | (2,746)      |
| Loans, net of deferred fees | \$ 3,451,382 | \$ 2,965,200 |

At June 30, 2016 and December 31, 2015, home equity and consumer loans included overdraft deposit balances of \$512,000 and \$705,000, respectively. At June 30, 2016 and December 31, 2015, the Company had \$807.0 million and \$738.7 million in loans pledged for actual and potential borrowings at the Federal Home Loan Bank of New York ( FHLB ).



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The carrying value of loans acquired in the Pascack acquisition and accounted for in accordance with ASC Subtopic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, was \$0.8 million at June 30, 2016, which was substantially the same as the balance at the Pascack acquisition date of January 7, 2016. Under ASC Subtopic 310-30, these loans, referred to as purchased credit impaired (PCI) loans, may be aggregated and accounted for as pools of loans if the loans being aggregated have common risk characteristics. The Company elected to account for the loans with evidence of credit deterioration individually rather than aggregate them into pools. The difference between the undiscounted cash flows expected at acquisition and the investment in the acquired loans, or the accretable yield, is recognized as interest income utilizing the level-yield method over the life of each loan. Contractually required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the non-accretable difference, are not recognized as a yield adjustment, as a loss accrual or as a valuation allowance.

Increases in expected cash flows subsequent to the acquisition are recognized prospectively through an adjustment of the yield on the loans over the remaining life, while decreases in expected cash flows are recognized as impairments through a loss provision and an increase in the allowance for loan and lease losses. Valuation allowances (recognized in the allowance for loan and lease losses) on these impaired loans reflect only losses incurred after the acquisition (representing all cash flows that were expected at acquisition but currently are not expected to be received).

There were no material increases or decreases in the expected cash flows between acquisition date and June 30, 2016. The Company recognized \$31,000 of interest income on the credit impaired loans acquired.

*Non-Performing Assets and Past Due Loans*

The following schedule sets forth certain information regarding the Company's non-performing assets and its accruing troubled debt restructurings, excluding PCI loans:

| (in thousands)                                 | June 30,<br>2016 | December 31,<br>2015 |
|--|------------------|----------------------|
| Commercial, secured by real estate             | \$ 12,554        | \$ 10,446            |
| Commercial, industrial and other               | 41               | 103                  |
| Leases   | 159              | 316                  |
| Real estate - residential mortgage             | 8,865            | 8,664                |
| Home equity and consumer                       | 3,325            | 3,167                |
| Total non-accrual loans and leases             | \$ 24,944        | \$ 22,696            |
| Other real estate and other repossessed assets | 1,594            | 983                  |
| <b>TOTAL NON-PERFORMING ASSETS</b>             | <b>\$ 26,538</b> | <b>\$ 23,679</b>     |
| Troubled debt restructurings, still accruing   | \$ 9,509         | \$ 10,108            |

Non-accrual loans included \$2.4 million and \$2.5 million of troubled debt restructurings as of June 30, 2016 and December 31, 2015, respectively. As of June 30, 2016 and December 31, 2015, the Company had \$7.0 million and \$7.9 million, respectively, in residential mortgages and consumer home equity loans that were in the process of foreclosure.



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An age analysis of past due loans, segregated by class of loans as of June 30, 2016 and December 31, 2015, is as follows:

|                                    | 30-59 Days<br>Past<br>Due | 60-89 Days<br>Past<br>Due | Greater<br>Than<br>89 Days<br>Past<br>Due | Total<br>Past<br>Due<br>(in thousands) | Current      | Total<br>Loans<br>and Leases | Recorded<br>Investment Greater<br>than 89<br>Days and<br>Still<br>Accruing |
|------------------------------------|---------------------------|---------------------------|---|--|--------------|------------------------------|--|
| <b>June 30, 2016</b>               |                           |                           |   |  |              |                              |  |
| Commercial, secured by real estate | \$ 5,357                  | \$ 4,150                  | \$ 9,269                                  | \$ 18,776                              | \$ 2,181,371 | \$ 2,200,147                 | \$   |
| Commercial, industrial and other   | 792                       | 213                       | 136                                       | 1,141                                  | 311,921      | 313,062                      |  |
| Leases                             | 145                       | 25                        | 159                                       | 329                                    | 63,009       | 63,338                       |  |
| Real estate - residential mortgage | 2,168                     | 1,263                     | 6,906                                     | 10,337                                 | 373,486      | 383,823                      |  |
| Real estate - construction         |                           |                           |   |  | 152,978      | 152,978                      |  |
| Home equity and consumer           | 650                       | 146                       | 2,568                                     | 3,364                                  | 337,592      | 340,956                      | 42   |
|                                    | \$ 9,112                  | \$ 5,797                  | \$ 19,038                                 | \$ 33,947                              | \$ 3,420,357 | \$ 3,454,304                 | \$ 42  |
| <b>December 31, 2015</b>           |                           |                           |   |  |              |                              |  |
| Commercial, secured by real estate | \$ 1,465                  | \$ 693                    | \$ 7,853                                  | \$ 10,011                              | \$ 1,751,578 | \$ 1,761,589                 | \$   |
| Commercial, industrial and other   | 205                       |                           | 103                                       | 308                                    | 306,736      | 307,044                      |  |
| Leases                             | 62                        | 26                        | 316                                       | 404                                    | 56,256       | 56,660                       |  |
| Real estate - residential mortgage | 1,361                     | 725                       | 7,472                                     | 9,558                                  | 380,134      | 389,692                      |  |
| Real estate - construction         |                           |                           |   |  | 118,070      | 118,070                      |  |
| Home equity and consumer           | 876                       | 141                       | 3,498                                     | 4,515                                  | 330,376      | 334,891                      | 331  |
|                                    | \$ 3,969                  | \$ 1,585                  | \$ 19,242                                 | \$ 24,796                              | \$ 2,943,150 | \$ 2,967,946                 | \$ 331   |

**Impaired Loans**

The Company defines impaired loans as all non-accrual loans and leases with recorded investments of \$500,000 or greater. Impaired loans also includes all loans modified in troubled debt restructurings. Impaired loans as of June 30, 2016 and December 31, 2015 are as follows:

Contractual

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| June 30, 2016                      | Recorded<br>Investment in<br>Impaired Loans | Unpaid<br>Principal<br>Balance | Specific<br>Allowance<br>(in thousands) | Interest<br>Income<br>Recognized | Average<br>Investment in<br>Impaired Loans |
|------------------------------------|---|--------------------------------|---|----------------------------------|--|
| Loans without specific allowance:  |   |                                |   |                                  |  |
| Commercial, secured by real estate | \$ 12,615                                   | \$ 13,090                      | \$                                      | \$ 116                           | \$ 13,015                                  |
| Commercial, industrial and other   | 95  | 95                             |   | 2                                | 96   |
| Leases                             |   |                                |   |                                  |  |
| Real estate - residential mortgage | 3,129                                       | 3,146                          |   | 8                                | 2,084                                      |
| Real estate - construction         |   |                                |   |                                  |  |
| Home equity and consumer           | 537   | 537                            |   |                                  | 545  |
| Loans with specific allowance:     |   |                                |   |                                  |  |
| Commercial, secured by real estate | 7,630                                       | 8,143                          | 493                                     | 145                              | 6,924                                      |
| Commercial, industrial and other   | 916   | 916                            | 43                                      | 20                               | 938  |
| Leases                             |   |                                |   |                                  |  |
| Real estate - residential mortgage | 934   | 1,008                          | 31                                      | 15                               | 938  |
| Real estate - construction         |   |                                |   |                                  |  |
| Home equity and consumer           | 1,247                                       | 1,406                          | 103                                     | 30                               | 1,201                                      |
| Total:                             |   |                                |   |                                  |  |
| Commercial, secured by real estate | \$ 20,245                                   | \$ 21,233                      | \$ 493                                  | \$ 261                           | \$ 19,939                                  |
| Commercial, industrial and other   | 1,011                                       | 1,011                          | 43                                      | 22                               | 1,034                                      |
| Leases                             |   |                                |   |                                  |  |
| Real estate - residential mortgage | 4,063                                       | 4,154                          | 31                                      | 23                               | 3,022                                      |
| Real estate - construction         |   |                                |   |                                  |  |
| Home equity and consumer           | 1,784                                       | 1,943                          | 103                                     | 30                               | 1,746                                      |
|                                    | \$ 27,103                                   | \$ 28,341                      | \$ 670                                  | \$ 336                           | \$ 25,744                                  |

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| December 31, 2015                        | Recorded<br>Investment in<br>Impaired Loans | Contractual<br>Unpaid<br>Principal<br>Balance | Specific<br>Allowance<br>(in thousands) | Interest<br>Income<br>Recognized | Average<br>Investment<br>in<br>Impaired Loans |
|--|---|---|---|----------------------------------|---|
| <b>Loans without specific allowance:</b> |   |   |   |                                  |   |
| Commercial, secured by real estate       | \$ 14,065                                   | \$ 14,712                                     | \$                                      | \$ 344                           | \$ 12,928                                     |
| Commercial, industrial and other         | 209   | 887   |   | 14                               | 749   |
| <b>Leases</b>                            |   |   |   |                                  |   |
| Real estate - residential mortgage       | 2,195                                       | 2,242   |   |                                  | 2,096   |
| Real estate - construction               |   |   |   |                                  | 94  |
| Home equity and consumer                 | 574   | 575   |   | 5                                | 762   |
| <b>Loans with specific allowance:</b>    |   |   |   |                                  |   |
| Commercial, secured by real estate       | 5,721                                       | 5,918   | 598                                     | 271                              | 6,249   |
| Commercial, industrial and other         | 1,023                                       | 1,023   | 77                                      | 32                               | 717   |
| Leases                                   | 6   | 6   | 1                                       |                                  |   |
| Real estate - residential mortgage       | 832   | 865   | 73                                      | 37                               | 840   |
| Real estate - construction               | 380   | 380   | 21                                      | 13                               | 308   |
| Home equity and consumer                 | 1,001                                       | 1,013   | 73                                      | 54                               | 1,006   |
| <b>Total:</b>                            |   |   |   |                                  |   |
| Commercial, secured by real estate       | \$ 19,786                                   | \$ 20,630                                     | \$ 598                                  | \$ 615                           | \$ 19,177                                     |
| Commercial, industrial and other         | 1,232                                       | 1,910   | 77                                      | 46                               | 1,466   |
| Leases                                   | 6   | 6   | 1                                       |                                  |   |
| Real estate - residential mortgage       | 3,027                                       | 3,107   | 73                                      | 37                               | 2,936   |
| Real estate - construction               | 380   | 380   | 21                                      | 13                               | 402   |
| Home equity and consumer                 | 1,575                                       | 1,588   | 73                                      | 59                               | 1,768   |
|  | \$ 26,006                                   | \$ 27,621                                     | \$ 843                                  | \$ 770                           | \$ 25,749                                     |

Interest income recognized on impaired loans was \$336,000 and \$394,000, respectively, for the six months ended June 30, 2016 and 2015. Interest that would have been accrued on impaired loans during the first six months of 2016 and 2015 had the loans been performing under original terms would have been \$828,000 and \$794,000, respectively.

*Credit Quality Indicators*

The class of loans is determined by internal risk rating. Management closely and continually monitors the quality of its loans and leases and assesses the quantitative and qualitative risks arising from the credit quality of its loans and leases. Lakeland assigns a credit risk rating to all commercial loans and loan commitments. The credit risk rating system has been developed by management to provide a methodology to be used by loan officers, department heads and senior management in identifying various levels of credit risk that exist within Lakeland's loan portfolios. The risk rating system assists senior management in evaluating Lakeland's commercial loan portfolio, analyzing trends, and determining the proper level of required reserves to be recommended to the Board. In assigning risk ratings, management considers, among other things, a borrower's debt service coverage, earnings strength, loan to value ratios, industry conditions and economic conditions. Management categorizes commercial loans and commitments into a one (1) to nine (9) numerical structure with rating 1 being the strongest rating and rating 9 being the weakest. Ratings 1 through 5W are considered Pass ratings.



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The following table shows the Company's commercial loan portfolio as of June 30, 2016 and December 31, 2015, by the risk ratings discussed above (in thousands):

|                                       | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Real<br>Estate-<br>Construction |
|---------------------------------------|--|--|---------------------------------|
| June 30, 2016                         |  |  |                                 |
| <b>Risk Rating</b>                    |  |  |                                 |
| 1                                     | \$                                       | \$ 4,790                               | \$                              |
| 2                                     |  | 12,859                                 |                                 |
| 3                                     | 90,333                                   | 39,328                                 |                                 |
| 4                                     | 664,396                                  | 120,918                                | 21,003                          |
| 5                                     | 1,299,359                                | 111,842                                | 128,998                         |
| 5W - Watch                            | 74,293                                   | 8,824                                  | 271                             |
| 6 - Other assets especially mentioned | 23,139                                   | 4,918                                  | 1,472                           |
| 7 - Substandard                       | 48,627                                   | 9,583                                  | 1,234                           |
| 8 - Doubtful                          |  |  |                                 |
| 9 - Loss                              |  |  |                                 |
| Total                                 | \$ 2,200,147                             | \$ 313,062                             | \$ 152,978                      |

|                                       | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Real<br>Estate-<br>Construction |
|---------------------------------------|--|--|---------------------------------|
| December 31, 2015                     |  |  |                                 |
| <b>Risk Rating</b>                    |  |  |                                 |
| 1                                     | \$                                       | \$ 3,517                               | \$                              |
| 2                                     |  | 9,662                                  |                                 |
| 3                                     | 65,199                                   | 56,895                                 |                                 |
| 4                                     | 526,909                                  | 111,702                                | 19,125                          |
| 5                                     | 1,044,888                                | 105,301                                | 94,535                          |
| 5W - Watch                            | 43,342                                   | 4,259                                  | 146                             |
| 6 - Other assets especially mentioned | 34,570                                   | 4,105                                  | 1,851                           |
| 7 - Substandard                       | 46,681                                   | 11,603                                 | 2,413                           |
| 8 - Doubtful                          |  |  |                                 |
| 9 - Loss                              |  |  |                                 |
| Total                                 | \$ 1,761,589                             | \$ 307,044                             | \$ 118,070                      |

The risk rating tables above do not include consumer or residential loans or leases because they are evaluated on their payment status.

*Allowance for Loan and Lease Losses*

In 2015, the Company refined and enhanced its assessment of the adequacy of the allowance for loan and lease losses by extending the lookback period on its commercial loan portfolios from three years to five years and by extending the lookback period for all other portfolios from two to three years in order to capture more of the economic cycle. It also enhanced its qualitative factor framework to include a factor that captures the risk related to appraised real estate values, and how those values could change in relation to a change in capitalization rates. This enhancement is meant to increase the level of precision in the allowance for loan and lease losses. As a result, the Company no longer has an unallocated segment in its allowance for loan losses, as the risks and uncertainties meant to be captured by the unallocated allowance have been included in the qualitative framework for the respective portfolios.



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The following table details activity in the allowance for loan and lease losses by portfolio segment for the three and six months ended June 30, 2016 and 2015:

|   | Commercial Secured by Real Estate | Commercial, Industrial and Other | Leases | Real Estate- Residential Mortgage | Real Estate- Construction | Home Equity and Consumer | Total          |
|---|-----------------------------------|----------------------------------|--------|-----------------------------------|---------------------------|--------------------------|----------------|
| <b>Three Months Ended June 30, 2016</b> |                                   |                                  |        |                                   |                           |                          | (in thousands) |
| Beginning Balance                       | \$ 20,077                         | \$ 2,597                         | \$ 588 | \$ 2,266                          | \$ 1,504                  | \$ 3,521                 | \$ 30,553      |
| Charge-offs                             | (139)                             | (171)                            | (205)  | (213)                             |                           | (317)                    | (1,045)        |
| Recoveries                              | 26                                | 34                               | 21     | 1                                 |                           | 67                       | 149            |
| Provision                               | 395                               | (248)                            | 220    | 110                               | 284                       | 249                      | 1,010          |
| Ending Balance                          | \$ 20,359                         | \$ 2,212                         | \$ 624 | \$ 2,164                          | \$ 1,788                  | \$ 3,520                 | \$ 30,667      |

|   | Commercial Secured by Real Estate | Commercial, Industrial and Other | Leases   | Real Estate- Residential Mortgage | Real Estate- Construction | Home Equity and Consumer | Unallocated | Total          |
|---|-----------------------------------|----------------------------------|----------|-----------------------------------|---------------------------|--------------------------|-------------|----------------|
| <b>Three Months Ended June 30, 2015</b> |                                   |                                  |          |                                   |                           |                          |             | (in thousands) |
| Beginning Balance                       | \$ 12,560                         | \$ 3,307                         | \$ 1,038 | \$ 3,298                          | \$ 637                    | \$ 6,924                 | \$ 2,741    | \$ 30,505      |
| Charge-offs                             | (805)                             | (64)                             | (102)    | (89)                              |                           | (415)                    |             | (1,475)        |
| Recoveries                              | 325                               | 42                               |          | 2                                 | 6                         | 29                       |             | 404            |
| Provision                               | 1,839                             | (417)                            | 18       | (195)                             | 82                        | (619)                    | 32          | 740            |
| Ending Balance                          | \$ 13,919                         | \$ 2,868                         | \$ 954   | \$ 3,016                          | \$ 725                    | \$ 5,919                 | \$ 2,773    | \$ 30,174      |

|                                       | Commercial Secured by Real Estate | Commercial, Industrial and Other | Leases | Real Estate- Residential Mortgage | Real Estate- Construction | Home Equity and Consumer | Total          |
|---------------------------------------|-----------------------------------|----------------------------------|--------|-----------------------------------|---------------------------|--------------------------|----------------|
| <b>Six Months Ended June 30, 2016</b> |                                   |                                  |        |                                   |                           |                          | (in thousands) |
| Beginning Balance                     | \$ 20,223                         | \$ 2,637                         | \$ 460 | \$ 2,588                          | \$ 1,591                  | \$ 3,375                 | \$ 30,874      |
| Charge-offs                           | (274)                             | (796)                            | (275)  | (306)                             |                           | (937)                    | (2,588)        |

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|            |     |     |     |       |     |     |       |
|------------|-----|-----|-----|-------|-----|-----|-------|
| Recoveries | 81  | 76  | 22  | 4     |     | 113 | 296   |
| Provision  | 329 | 295 | 417 | (122) | 197 | 969 | 2,085 |

Ending Balance \$ 20,359 \$ 2,212 \$ 624 \$ 2,164 \$ 1,788 \$ 3,520 \$ 30,667

|                                       | Commercial Secured by Real Estate | Commercial, Industrial and Other | Real Estate- Leases | Real Estate- Residential Mortgage | Real Estate- Construction | Home Equity and Consumer | Unallocated | Total          |
|---------------------------------------|-----------------------------------|----------------------------------|---------------------|-----------------------------------|---------------------------|--------------------------|-------------|----------------|
| <b>Six Months Ended June 30, 2015</b> |                                   |                                  |                     |                                   |                           |                          |             |                |
|                                       |                                   |                                  |                     |                                   |                           |                          |             | (in thousands) |
| Beginning Balance                     | \$ 13,577                         | \$ 3,196                         | \$ 582              | \$ 4,020                          | \$ 553                    | \$ 6,333                 | \$ 2,423    | \$ 30,684      |
| Charge-offs                           | (1,351)                           | (74)                             | (529)               | (106)                             | (20)                      | (676)                    |             | (2,756)        |
| Recoveries                            | 364                               | 84                               | 20                  | 3                                 | 106                       | 59                       |             | 636            |
| Provision                             | 1,329                             | (338)                            | 881                 | (901)                             | 86                        | 203                      | 350         | 1,610          |
| Ending Balance                        | \$ 13,919                         | \$ 2,868                         | \$ 954              | \$ 3,016                          | \$ 725                    | \$ 5,919                 | \$ 2,773    | \$ 30,174      |

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Loans receivable summarized by portfolio segment and impairment method are as follows:

| June 30, 2016  | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Leases    | Real Estate-<br>Residential<br>Mortgage<br>(in thousands) | Real<br>Estate-<br>Construction | Home<br>Equity and<br>Consumer | Total        |
|--|--|--|-----------|---|---------------------------------|--------------------------------|--------------|
| Ending Balance:<br>Individually evaluated<br>for impairment              | \$ 20,245                                | \$ 1,011                               | \$        | \$ 4,063  | \$                              | \$ 1,784                       | \$ 27,103    |
| Ending Balance:<br>Collectively evaluated<br>for impairment              | 2,179,493                                | 311,720                                | 63,338    | 379,760   | 152,978                         | 339,153                        | \$ 3,426,442 |
| Ending Balance: Loans<br>acquired with<br>deteriorated credit<br>quality | 409                                      | 331                                    |           |   |                                 | 19                             | \$ 759       |
| Ending Balance (1)   | \$ 2,200,147                             | \$ 313,062                             | \$ 63,338 | \$ 383,823  | \$ 152,978                      | \$ 340,956                     | \$ 3,454,304 |

(1) Excludes deferred fees

| December 31, 2015   | Commercial,<br>Secured by<br>Real Estate | Commercial,<br>Industrial<br>and Other | Leases    | Real Estate-<br>Residential<br>Mortgage<br>(in thousands) | Real<br>Estate-<br>Construction | Home<br>Equity and<br>Consumer | Total        |
|---|--|--|-----------|---|---------------------------------|--------------------------------|--------------|
| Ending Balance:<br>Individually evaluated<br>for impairment | \$ 19,786                                | \$ 1,232                               | \$ 6      | \$ 3,027  | \$ 380                          | \$ 1,575                       | \$ 26,006    |
| Ending Balance:<br>Collectively evaluated<br>for impairment | 1,741,803                                | 305,812                                | 56,654    | 386,665   | 117,690                         | 333,316                        | \$ 2,941,940 |
| Ending Balance (1)  | \$ 1,761,589                             | \$ 307,044                             | \$ 56,660 | \$ 389,692  | \$ 118,070                      | \$ 334,891                     | \$ 2,967,946 |

(1) Excludes deferred fees

**Table of Contents**

The allowance for loan and lease losses is summarized by portfolio segment and impairment classification as follows:

|  | Commercial<br>Secured<br>by<br>Real<br>Estate | Commercial,<br>Industrial<br>and<br>Other | Leases | Real Estate-<br>Residential<br>Mortgage | Real<br>Estate-<br>Construction | Home<br>Equity<br>and<br>Consumer | Total     |
|--|---|---|--------|---|---------------------------------|-----------------------------------|-----------|
| June 30, 2016  |   |   |        | (in thousands)                          |                                 |                                   |           |
| Ending Balance: Individually<br>evaluated for impairment | \$ 493  | \$ 43                                     | \$     | \$ 31                                   | \$                              | \$ 103                            | \$ 670    |
| Ending Balance: Collectively<br>evaluated for impairment | 19,866  | 2,169                                     | 624    | 2,133                                   | 1,788                           | 3,417                             | \$ 29,997 |
| Ending Balance   | \$ 20,359                                     | \$ 2,212                                  | \$ 624 | \$ 2,164                                | \$ 1,788                        | \$ 3,520                          | \$ 30,667 |

|  | Commercial<br>Secured<br>by<br>Real<br>Estate | Commercial,<br>Industrial<br>and<br>Other | Leases | Real Estate-<br>Residential<br>Mortgage | Real<br>Estate-<br>Construction | Home<br>Equity<br>and<br>Consumer | Total     |
|--|---|---|--------|---|---------------------------------|-----------------------------------|-----------|
| December 31, 2015  |   |   |        | (in thousands)                          |                                 |                                   |           |
| Ending Balance: Individually<br>evaluated for impairment | \$ 598  | \$ 77                                     | \$ 1   | \$ 73                                   | \$ 21                           | \$ 73                             | \$ 843    |
| Ending Balance: Collectively<br>evaluated for impairment | 19,625  | 2,560                                     | 459    | 2,515                                   | 1,570                           | 3,302                             | \$ 30,031 |
| Ending Balance   | \$ 20,223                                     | \$ 2,637                                  | \$ 460 | \$ 2,588                                | \$ 1,591                        | \$ 3,375                          | \$ 30,874 |

Lakeland also maintains a reserve for unfunded lending commitments which is included in other liabilities. This reserve was \$2.5 million and \$2.0 million at June 30, 2016 and December 31, 2015, respectively. The Company analyzes the adequacy of the reserve for unfunded lending commitments in conjunction with its analysis of the adequacy of the allowance for loan and lease losses. For more information on this analysis, see Risk Elements in Management's Discussion and Analysis.

*Troubled Debt Restructurings*

Troubled debt restructurings are those loans where concessions have been made due to borrowers' financial difficulties. Restructured loans typically involve a modification of terms such as a reduction of the stated interest rate, a moratorium of principal payments and/or an extension of the maturity date at a stated interest rate lower than the current market rate of a new loan with similar risk. The Company considers the potential losses on these loans as well as the remainder of its impaired loans while considering the adequacy of the allowance for loan and lease losses.

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The following table summarizes loans that have been restructured during the three and six months ended June 30, 2016 and 2015:

|                                     | For the Three Months Ended<br>June 30, 2016 |                                      |                        | For the Three Months Ended<br>June 30, 2015 |                                      |          |
|-------------------------------------|---|--------------------------------------|------------------------|---|--------------------------------------|----------|
|                                     | Pre-<br>Modification<br>Outstanding         | Post-<br>Modification<br>Outstanding |                        | Pre-<br>Modification<br>Outstanding         | Post-<br>Modification<br>Outstanding |          |
|                                     | Number of<br>Contracts                      | Recorded<br>Investment               |                        | Number of<br>Contracts                      | Recorded<br>Investment               |          |
|                                     |   |                                      | (dollars in thousands) |   |                                      |          |
| <b>Troubled Debt Restructurings</b> |   |                                      |                        |   |                                      |          |
| Commercial, secured by real estate  |   | \$                                   | \$                     | 2   | \$ 1,458                             | \$ 1,458 |
| Commercial, industrial and other    |   |                                      |                        | 2   | 784                                  | 784      |
|                                     |   | \$                                   | \$                     | 4   | \$ 2,242                             | \$ 2,242 |
|                                     |   |                                      |                        |   |                                      |          |
|                                     | For the Six Months Ended<br>June 30, 2016   |                                      |                        | For the Six Months Ended<br>June 30, 2015   |                                      |          |
|                                     | Pre-<br>Modification<br>Outstanding         | Post-<br>Modification<br>Outstanding |                        | Pre-<br>Modification<br>Outstanding         | Post-<br>Modification<br>Outstanding |          |
|                                     | Number<br>of<br>Contracts                   | Recorded<br>Investment               |                        | Number<br>of<br>Contracts                   | Recorded<br>Investment               |          |
|                                     |   |                                      | (dollars in thousands) |   |                                      |          |
| <b>Troubled Debt Restructurings</b> |   |                                      |                        |   |                                      |          |
| Commercial, secured by real estate  |   | \$                                   | \$                     | 2   | \$ 1,458                             | \$ 1,458 |
| Commercial, industrial and other    |   |                                      |                        | 3   | 1,933                                | 1,933    |
| Leases                              |   |                                      |                        | 1   | 14                                   | 14       |
| Real estate - construction          |   |                                      |                        | 1   | 396                                  | 396      |
| Home equity and consumer            | 3   | 285                                  | 285                    | 1   | 9                                    | 9        |
|                                     | 3   | \$ 285                               | \$ 285                 | 8   | \$ 3,810                             | \$ 3,810 |

The following table summarizes as of June 30, 2016 and 2015, loans that were restructured within the previous twelve months that have subsequently defaulted:

|  | June 30, 2016          |                        | June 30, 2015          |                        |
|--|------------------------|------------------------|------------------------|------------------------|
|  | Number of<br>Contracts | Recorded<br>Investment | Number of<br>Contracts | Recorded<br>Investment |
|  |                        |                        |                        | (dollars in thousands) |

**Defaulted Troubled Debt Restructurings**

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|                                    |   |    |     |   |    |     |
|------------------------------------|---|----|-----|---|----|-----|
| Real estate - residential mortgage |   | \$ |     | 1 | \$ | 483 |
| Home equity and consumer           | 1 |    | 162 |   |    |     |
|                                    | 1 | \$ | 162 | 1 | \$ | 483 |

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*Other Real Estate and Other Repossessed Assets*

At June 30, 2016, the Company had other real estate owned of \$1.6 million. It had no other repossessed assets as of June 30, 2016. At December 31, 2015, the Company had other real estate owned and other repossessed assets of \$934,000 and \$49,000, respectively. The other real estate owned that the Company held at June 30, 2016 and December 31, 2015 included \$1.0 million and \$805,000, respectively, in residential property acquired as a result of foreclosure proceedings or through a deed in lieu of foreclosure.

**Note 6. Derivatives**

Lakeland is a party to interest rate derivatives that are not designated as hedging instruments. Under a program, Lakeland executes interest rate swaps with commercial lending customers to facilitate their respective risk management strategies. These interest rate swaps with customers are simultaneously offset by interest rate swaps that Lakeland executes with a third party, such that Lakeland minimizes its net risk exposure resulting from such transactions. Because the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. The changes in the fair value of the swaps offset each other, except for the credit risk of the counterparties, which is determined by taking into consideration the risk rating, probability of default and loss given default for all counterparties. As of June 30, 2016 and December 31, 2015, Lakeland had \$7.2 million and \$2.5 million, respectively, in available for sale securities pledged for collateral on its interest rate swaps with the financial institution.

In June 2016, the Company entered into two cash flow hedges in order to hedge the variable cash outflows associated with its subordinated debentures. The notional value of these hedges was \$30.0 million. The Company's objectives in using the cash flow hedge is to add stability to interest expense and to manage its exposure to interest rate movements. The Company used interest rate swaps designated as cash flow hedges which involved the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount. In these particular hedges the Company is paying a third party an average of 1.10% in exchange for a payment at 3 month LIBOR. The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges are recorded in accumulated other comprehensive income and are subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During the six months ended June 30, 2016, the Company did not record any hedge ineffectiveness.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Company's debt. During the next twelve months, the Company estimates that \$141,000 will be reclassified as an increase to interest expense should the rate environment remain the same.

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The following table presents summary information regarding these derivatives for the periods presented (dollars in thousands):

|                                      |                 | Average          | Weighted Average |                   |            |
|--------------------------------------|-----------------|------------------|------------------|-------------------|------------|
| June 30, 2016                        | Notional Amount | Maturity (Years) | Fixed Rate       | Variable Rate     | Fair Value |
| Customer interest rate swaps         | \$ 82,229       | 11.8             | 4.13%            | 1 Mo Libor + 2.01 | \$ 6,078   |
| 3rd Party interest rate swaps        | (82,229)        | 11.8             | 4.13%            | 1 Mo Libor + 2.01 | (6,078)    |
| Interest rate swap (cash flow hedge) | 30,000          | 5                | 1.10%            | 3 Mo. Libor       | (193)      |

|                               |                 | Average          | Weighted           |                   |            |
|-------------------------------|-----------------|------------------|--------------------|-------------------|------------|
| December 31, 2015             | Notional Amount | Maturity (Years) | Average Fixed Rate | Variable Rate     | Fair Value |
| Customer interest rate swaps  | \$ 35,664       | 14.6             | 4.54%              | 1 Mo Libor + 2.00 | \$ 1,518   |
| 3rd party interest rate swaps | (35,664)        | 14.6             | 4.54%              | 1 Mo Libor + 2.00 | (1,518)    |

**Note 7. Goodwill and Intangible Assets**

The Company has recorded goodwill of \$125.3 million and \$110.0 million at June 30, 2016 and December 31, 2015, respectively, which includes \$15.3 million from the Pascack merger in 2016, \$22.9 million from the Somerset Hills acquisition in 2013 and \$87.1 million from prior acquisitions. The Company reviews its goodwill and intangible assets annually, on November 30, or more frequently if conditions warrant, for impairment. In testing goodwill for impairment, the Company compares the estimated fair value of its reporting unit to its carrying amount, including goodwill. The Company has determined that it has one reporting unit, Community Banking.

The Company recorded \$1.5 million and \$2.7 million in core deposit intangible for the Pascack and Somerset Hills acquisitions, respectively. Year-to-date, it has amortized \$331,000 in core deposit intangible including \$138,000 and \$193,000 for Pascack and Somerset Hills, respectively. The estimated future amortization expense for the remainder of 2016 and for each of the succeeding five years ended December 31 is as follows (dollars in thousands):

| For the Year Ended | Pascack | Somerset Hills |
|--------------------|---------|----------------|
| 2016               | \$ 138  | \$ 173         |
| 2017               | 248     | 316            |
| 2018               | 220     | 267            |
| 2019               | 193     | 218            |
| 2020               | 165     | 168            |
| 2021               | 138     | 119            |

**Note 8. Borrowings**

At June 30, 2016, the Company had federal funds purchased and securities sold under agreements to repurchase of \$99.6 million and \$24.0 million respectively. The securities sold under agreements to repurchase are overnight sweep arrangement accounts with our customers. The Company also had \$50.0 million in long-term securities sold under



agreements to repurchase included in other borrowings which have maturities ranging from one to seven years. As of June 30, 2016, the Company had \$102.5 million in mortgage backed securities pledged for its securities sold under agreements to repurchase.

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At times the market values of securities collateralizing our securities sold under agreements to repurchase may decline due to changes in interest rates and may necessitate our lenders to issue a margin call which requires Lakeland to pledge additional collateral to meet that margin call.

**Note 9. Share-Based Compensation**

The Company grants restricted stock, restricted stock units (RSUs) and stock options under the 2009 Equity Compensation Program. Share-based compensation expense of \$1.1 million and \$912,000 was recognized for the six months ended June 30, 2016 and 2015, respectively. As of June 30, 2016, there was unrecognized compensation cost of \$240,000 related to unvested restricted stock that is expected to be recognized over a weighted average period of approximately 0.59 years. Unrecognized compensation expense related to RSUs was approximately \$1.7 million as of June 30, 2016, and that cost is expected to be recognized over a period of 1.36 years. Unrecognized compensation expense related to unvested stock options was approximately \$32,000 as of June 30, 2016 and is expected to be recognized over a period of 0.92 years.

In the first six months of 2016, the Company granted 23,952 shares of restricted stock to non-employee directors at a grant date fair value of \$10.02 per share under the 2009 Equity Compensation Program. The restricted stock vests one year from the date it was granted. Compensation expense on this restricted stock is expected to be \$240,000 over a one year period.

Information regarding the Company's restricted stock and changes during the six months ended June 30, 2016 is as follows:

|                              | Number of<br>Shares | Weighted<br>Average<br>Price |
|------------------------------|---------------------|------------------------------|
| Outstanding, January 1, 2016 | 73,500              | \$ 9.33                      |
| Granted                      | 23,952              | 10.02                        |
| Vested                       | (54,360)            | 9.33                         |
| Forfeited                    | (168)               | 9.12                         |
| Outstanding, June 30, 2016   | 42,924              | \$ 9.72                      |

In the first six months of 2016, the Company granted 150,226 RSUs to certain officers at a weighted average grant date fair value of \$10.06 per share under the Company's 2009 Equity Compensation Program. These units vest within a range of two to three years. A portion of these RSUs will vest subject to certain performance conditions in the restricted stock unit agreement. There are also certain provisions in the compensation program which state that if a recipient of the RSUs reaches a certain age and years of service, the person has effectively earned a portion of the RSUs at that time. Compensation expense on the restricted stock units issued in the first half of 2016 is expected to average approximately \$504,000 per year over a three year period. In the first six months of 2015, the Company granted 129,509 RSUs at a weighted average grant date fair value of \$11.06 per share under the Company's 2009 Equity Compensation Program. Compensation expense on these restricted stock units is expected to average approximately \$477,000 per year over a three year period.



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Information regarding the Company's RSUs and changes during the six months ended June 30, 2016 is as follows:

|                              | Number of<br>Shares | Weighted<br>Average<br>Price |
|------------------------------|---------------------|------------------------------|
| Outstanding, January 1, 2016 | 200,910             | \$ 10.87                     |
| Granted                      | 150,226             | 10.06                        |
| Vested                       | (66,749)            | 10.28                        |
| Forfeited                    | (6,157)             | 10.65                        |
| Outstanding, June 30, 2016   | 278,230             | \$ 10.58                     |

There were no grants of stock options in the first six months of 2016 or 2015. Option activity under the Company's stock option plans is as follows:

|                                      | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term<br>(in years) | Aggregate<br>Intrinsic<br>Value |
|--------------------------------------|---------------------|--|---|---------------------------------|
| Outstanding, January 1, 2016         | 175,892             | \$ 8.38                                  |   | \$ 602,236                      |
| Granted                              |                     |  |   |                                 |
| Exercised                            |                     |  |   |                                 |
| Forfeited                            |                     |  |   |                                 |
| Expired                              |                     |  |   |                                 |
| Outstanding, June 30, 2016           | 175,892             | \$ 8.38                                  | 4.53  | \$ 530,121                      |
| Options exercisable at June 30, 2016 | 165,274             | \$ 8.30                                  | 4.38  | \$ 509,241                      |

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the first six months of 2016 and the exercise price, multiplied by the number of in-the-money options).

The aggregate intrinsic value of stock options exercised during the six months ended June 30, 2015 was \$63,000. Exercise of stock options during the first six months of 2015 resulted in cash receipts of \$113,000.

**Table of Contents****Note 10. Comprehensive Income**

The components of other comprehensive income (loss) are as follows:

|   | Before<br>Tax<br>Amount | June 30, 2016<br>Tax<br>Benefit<br>(Expense)<br>(in thousands) | Net of<br>Tax<br>Amount | Before<br>Tax<br>Amount | June 30, 2015<br>Tax<br>Benefit<br>(Expense)<br>(in thousands) | Net of<br>Tax<br>Amount |
|---|-------------------------|--|-------------------------|-------------------------|--|-------------------------|
| For the quarter ended:  |                         |  |                         |                         |  |                         |
| Net unrealized gains (losses)<br>on available for sale securities         |                         |  |                         |                         |  |                         |
| Net unrealized holding gains<br>(losses) arising during period            | \$ 2,684                | (\$ 987)   | \$ 1,697                | (\$ 3,466)              | \$ 1,289   | (\$ 2,177)              |
| Reclassification adjustment<br>for net gains arising during the<br>period |                         |  |                         | (26)                    | 9  | (17)                    |
| Net unrealized gains (losses)   | \$ 2,684                | (\$ 987)   | \$ 1,697                | (\$ 3,492)              | \$ 1,298   | (\$ 2,194)              |
| Unrealized loss on derivatives  | (193)                   | 67   | (126)                   |                         |  |                         |
| Change in minimum pension<br>liability                                    | 8                       | (2)  | 6                       | 8                       | (3)  | 5                       |
| Other comprehensive income<br>(loss), net                                 | \$ 2,499                | (\$ 922)   | \$ 1,577                | (\$ 3,484)              | \$ 1,295   | (\$ 2,189)              |
|   | Before<br>Tax Amount    | Tax Benefit<br>(Expense)<br>(in thousands)                     | Net of<br>Tax Amount    | Before<br>Tax Amount    | Tax Benefit<br>(Expense)<br>(in thousands)                     | Net of<br>Tax Amount    |
| For the six months ended:   |                         |  |                         |                         |  |                         |
| Net unrealized gains on<br>available for sale securities                  |                         |  |                         |                         |  |                         |
| Net unrealized holding gains<br>arising during period                     | \$ 9,247                | (\$ 3,393)   | \$ 5,854                | \$ 759                  | (\$ 261)   | \$ 498                  |
| Reclassification adjustment<br>for net gains arising during the<br>period | (370)                   | 137  | (233)                   | (26)                    | 9  | (17)                    |
| Net unrealized gains  | \$ 8,877                | (\$ 3,256)   | \$ 5,621                | \$ 733                  | (\$ 252)   | \$ 481                  |
| Unrealized loss on derivatives  | (193)                   | 67   | (126)                   |                         |  |                         |
| Change in minimum pension<br>liability                                    | 72                      | (28)   | 44                      | 16                      | (6)  | 10                      |
|   | \$ 8,756                | (\$ 3,217)   | \$ 5,539                | \$ 749                  | (\$ 258)   | \$ 491                  |

Other comprehensive income,  
net

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The following table shows the changes in the balances of each of the components of other comprehensive income for the periods presented (in thousands):

## Changes in Accumulated Other Comprehensive Income by component, net of tax

|  | For the three months ended June 30, 2016 |                |                   |          | For the three months ended June 30, 2015 |               |          |  |
|--|--|----------------|-------------------|----------|--|---------------|----------|--|
|  | Unrealized Gains                         |                | Unrealized Losses |          | Unrealized Gains (Losses)                |               |          |  |
|  | on Available-for-Sale Securities         | on Derivatives | Pension Items     | Total    | on Available-for-Sale Securities         | Pension Items | Total    |  |
| Beginning Balance  | \$ 5,078                                 | \$             | \$ 34             | \$ 5,112 | \$ 4,206                                 | (\$ 3)        | \$ 4,203 |  |
| (in thousands)   |  |                |                   |          |  |               |          |  |
| Other comprehensive income (loss) before classifications         | 1,697                                    | (126)          | 6                 | 1,577    | (2,177)                                  | 5             | (2,172)  |  |
| Amounts reclassified from accumulated other comprehensive income |  |                |                   |          | (17)                                     |               | (17)     |  |
| Net current period other comprehensive income (loss)             | 1,697                                    | (126)          | 6                 | 1,577    | (2,194)                                  | 5             | (2,189)  |  |
| Ending Balance   | \$ 6,775                                 | (\$ 126)       | \$ 40             | \$ 6,689 | \$ 2,012                                 | \$ 2          | \$ 2,014 |  |

|  | For the six months ended June 30, 2016 |                |                   |          | For the six months ended June 30, 2015 |               |          |  |
|--|--|----------------|-------------------|----------|--|---------------|----------|--|
|  | Unrealized Gains                       |                | Unrealized Losses |          | Unrealized Gains                       |               |          |  |
|  | on Available-for-sale Securities       | on Derivatives | Pension Items     | Total    | on Available-for-sale Securities       | Pension Items | Total    |  |
| Beginning Balance  | \$ 1,154                               | \$             | (\$ 4)            | \$ 1,150 | \$ 1,531                               | (\$ 8)        | \$ 1,523 |  |
| Other comprehensive income before classifications                | 5,854                                  | (126)          | 44                | 5,772    | 498                                    | 10            | 508      |  |
| Amounts reclassified from accumulated other comprehensive income | (233)                                  |                |                   | (233)    | (17)                                   |               | (17)     |  |
| Net current period other comprehensive income                    | 5,621                                  | (126)          | 44                | 5,539    | 481                                    | 10            | 491      |  |
| Ending Balance   | \$ 6,775                               | (\$ 126)       | \$ 40             | \$ 6,689 | \$ 2,012                               | \$ 2          | \$ 2,014 |  |

## **Note 11. Estimated Fair Value of Financial Instruments and Fair Value Measurement**

### **Fair Value Measurement**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for an asset or liability in an orderly transaction between market participants at the measurement date. U.S. GAAP establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels giving the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest level priority to unobservable inputs (level 3 measurements). The following describes the three levels of fair value hierarchy:

Level 1 unadjusted quoted prices in active markets for identical assets or liabilities; includes U.S. Treasury Notes, and other U.S. Government Agency securities that actively trade in over-the-counter markets; equity securities and mutual funds that actively trade in over-the-counter markets.



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Level 2 quoted prices for similar assets or liabilities in active markets; or quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs other than quoted prices that are observable for the asset or liability including yield curves, volatilities, and prepayment speeds.

Level 3 unobservable inputs for the asset or liability that reflect the Company's own assumptions about assumptions that market participants would use in the pricing of the asset or liability and that are consequently not based on market activity but upon particular valuation techniques.

The Company's assets that are measured at fair value on a recurring basis are its available for sale investment securities. The Company obtains fair values on its securities using information from a third party servicer. If quoted prices for securities are available in an active market, those securities are classified as Level 1 securities. The Company has U.S. Treasury Notes and certain equity securities that are classified as Level 1 securities. Level 2 securities were primarily comprised of U.S. Agency bonds, residential mortgage-backed securities, obligations of state and political subdivisions and corporate securities. Fair values were estimated primarily by obtaining quoted prices for similar assets in active markets or through the use of pricing models supported with market data information. Standard inputs include benchmark yields, reported trades, issuer spreads, bids and offers. On a quarterly basis, the Company reviews the pricing information received from the Company's third party pricing service. This review includes a comparison to non-binding third-party quotes.

The fair values of derivatives are based on valuation models from a third party using current market terms (including interest rates and fees), the remaining terms of the agreements and the credit worthiness of the counter party as of the measurement date (Level 2).

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The following table sets forth the Company's financial assets that were accounted for at fair value on a recurring basis as of the periods presented by level within the fair value hierarchy. During the six months ended June 30, 2016, the Company did not make any transfers between any levels within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

|  | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--|------------|--|---|---|
| (in thousands)                                   |            |  |   |   |
| <b>June 30, 2016</b>                             |            |  |   |   |
| <b>Assets:</b>                                   |            |  |   |   |
| Investment securities, available for sale        |            |  |   |   |
| U.S. treasury and government agencies            | \$ 92,780  | \$ 6,060   | \$ 86,720                                     | \$  |
| Mortgage backed securities                       | 308,053    |  | 308,053                                       |   |
| Obligations of states and political subdivisions | 40,607     |  | 40,607  |   |
| Equity securities                                | 18,950     | 5,038  | 13,912  |   |
| Total securities available for sale              | 460,390    | 11,098   | 449,292                                       |   |
| Derivative Assets                                | 6,078      |  | 6,078   |   |
| Total Assets                                     | 466,468    | \$ 11,098  | \$ 455,370                                    | \$  |
| <b>Liabilities:</b>                              |            |  |   |   |
| Derivative Liabilities                           | \$ 6,271   | \$   | \$ 6,271                                      | \$  |
| Total Liabilities                                | \$ 6,271   | \$   | \$ 6,271                                      | \$  |
| <b>December 31, 2015</b>                         |            |  |   |   |
| <b>Assets:</b>                                   |            |  |   |   |
| Investment securities, available for sale        |            |  |   |   |
| U.S. treasury and government agencies            | \$ 97,133  | \$ 4,888   | \$ 92,245                                     | \$  |
| Mortgage backed securities                       | 289,572    |  | 289,572                                       |   |
| Obligations of states and political subdivisions | 36,498     |  | 36,498  |   |
| Other debt securities                            | 501        |  | 501   |   |
| Equity securities                                | 18,645     | 5,052  | 13,593  |   |
| Total securities available for sale              | 442,349    | 9,940  | 432,409                                       |   |
| Derivative Assets                                | 1,518      |  | 1,518   |   |
| Total Assets                                     | 443,867    | \$ 9,940   | \$ 433,927                                    | \$  |

|                        |    |       |    |          |
|------------------------|----|-------|----|----------|
| <b>Liabilities:</b>    |    |       |    |          |
| Derivative Liabilities | \$ | 1,518 | \$ | \$ 1,518 |
| Total Liabilities      | \$ | 1,518 | \$ | \$ 1,518 |

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The following table sets forth the Company's assets subject to fair value adjustments (impairment) on a nonrecurring basis. Assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

|  | Quoted Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) |    |       | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Fair Value |
|--|---|----|-------|---|--|---------------------|
|  | (in thousands)  |    |       |   |  |                     |
| <u>June 30, 2016</u>                                 |   |    |       |   |  |                     |
| <b>Assets:</b>                                       |   |    |       |   |  |                     |
| Impaired Loans and Leases                            | \$  | \$ |       | \$  | 27,103   | \$ 27,103           |
| Loans held for sale                                  |   |    | 6,463 |   |  | 6,463               |
| Other real estate owned and other repossessed assets |   |    |       |   | 1,594  | 1,594               |
| <u>December 31, 2015</u>                             |   |    |       |   |  |                     |
| <b>Assets:</b>                                       |   |    |       |   |  |                     |
| Impaired Loans and Leases                            | \$  | \$ |       | \$  | 26,006   | \$ 26,006           |
| Loans held for sale                                  |   |    | 1,233 |   |  | 1,233               |
| Other real estate owned and other repossessed assets |   |    |       |   | 983  | 983                 |

Impaired loans are evaluated and valued at the time the loan is identified as impaired at the lower of cost or market value of the underlying collateral. Because most of Lakeland's impaired loans are collateral dependent, fair value is generally measured based on the value of the collateral, less estimated costs to sell, securing these loans and leases and is classified at a level 3 in the fair value hierarchy. Collateral may be real estate, accounts receivable, inventory, equipment and/or other business assets. The value of the real estate is assessed based on appraisals by qualified third party licensed appraisers. The appraisers may use the sales comparison approach, the cost approach or the income approach to value the collateral using discount rates (with ranges of 5-11%) or capitalization rates (with ranges of 4-9%) to evaluate the property. The value of the equipment may be determined by an appraiser, if significant, inquiry through a recognized valuation resource, or by the value on the borrower's financial statements. Field examiner reviews on business assets may be conducted based on the loan exposure and reliance on this type of collateral. Appraised and reported values may be adjusted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Loans that are not collateral dependent are evaluated based on a discounted cash flow method. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

The Company has a held for sale loan portfolio that consists of residential mortgages that are being sold in the secondary market. The Company records these mortgages at the lower of cost or market value. Fair value is generally determined by the value of purchase commitments.

Other real estate owned (OREO) and other repossessed assets, representing property acquired through foreclosure, are recorded at fair value less estimated disposal costs of the acquired property on the date of acquisition and thereafter remeasured and carried at lower of cost or fair market value. Fair value on other real estate owned is based on the appraised value of the collateral using the sales comparison approach or the income approach with discount rates or capitalization rates similar to those used in impaired loan valuation. The fair value of other repossessed assets is estimated by inquiry through recognized valuation resources.

Changes in the assumptions or methodologies used to estimate fair values may materially affect the estimated amounts. Changes in economic conditions, locally or nationally, could impact the value of the estimated amounts of impaired loans, OREO and other repossessed assets.

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*Fair Value of Certain Financial Instruments*

Estimated fair values have been determined by the Company using the best available data and an estimation methodology suitable for each category of financial instruments. There may not be reasonable comparability between institutions due to the wide range of permitted assumptions and methodologies in the absence of active markets. This lack of uniformity gives rise to a high degree of subjectivity in estimating financial instrument fair values.

The estimation methodologies used, the estimated fair values, and recorded book balances at June 30, 2016 and December 31, 2015 are outlined below.

This summary, as well as the table below, excludes financial assets and liabilities for which carrying value approximates fair value. For financial assets, these include cash and cash equivalents. For financial liabilities, these include noninterest bearing demand deposits, savings and interest-bearing transaction accounts and federal funds sold and securities sold under agreements to repurchase. The estimated fair value of demand, savings and interest-bearing transaction accounts is the amount payable on demand at the reporting date. Carrying value is used because there is no stated maturity on these accounts, and the customer has the ability to withdraw the funds immediately. Also excluded from this summary and the following table are those financial instruments recorded at fair value on a recurring basis, as previously described.

The fair value of Investment Securities Held to Maturity was measured using information from the same third-party servicer used for Investment Securities Available for Sale using the same methodologies discussed above. Investment Securities Held to Maturity includes \$19.5 million in short-term municipal bond anticipation notes and \$1.0 million in subordinated debt that are non-rated and do not have an active secondary market or information readily available on standard financial systems. As a result, the securities are classified as Level 3 securities. These are investments that management performs a credit analysis on before investing in these securities.

FHLB stock is an equity interest that can be sold to the issuing FHLB, to other Federal Home Loan Banks, or to other member banks at its par value. Because ownership of these securities is restricted, they do not have a readily determinable fair value. As such, the Company's FHLB Stock is recorded at cost or par value and is evaluated for impairment each reporting period by considering the ultimate recoverability of the investment rather than temporary declines in value. The Company's evaluation primarily includes an evaluation of liquidity, capitalization, operating performance, commitments, and regulatory or legislative events.

The net loan portfolio at June 30, 2016 and December 31, 2015 has been valued using a present value discounted cash flow where market prices are not available. The discount rate used in these calculations is the estimated current market rate adjusted for credit risk. The valuation of the Company's loan portfolio is consistent with accounting guidance but does not fully incorporate the exit price approach.

For fixed maturity certificates of deposit, fair value is estimated based on the present value of discounted cash flows using the rates currently offered for deposits of similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

The fair value of long-term debt is based upon the discounted value of contractual cash flows. The Company estimates the discount rate using the rates currently offered for similar borrowing arrangements. The fair value of subordinated debentures is based on bid/ask prices from brokers for similar types of instruments.

The fair values of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present

creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of guarantees and letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. The fair value of commitments to extend credit and standby letters of credit are deemed immaterial.

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The following table presents the carrying values, fair values and placement in the fair value hierarchy of the Company's financial instruments as of June 30, 2016 and December 31, 2015:

|  | Carrying<br>Value | Fair<br>Value | Quoted Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1)<br>(in thousands) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--|-------------------|---------------|--|---|--|
| <b>June 30, 2016</b>                                       |                   |               |  |   |  |
| <b>Financial Instruments - Assets:</b>                     |                   |               |  |   |  |
| Investment securities held to maturity                     | \$ 126,221        | \$ 129,447    | \$   | \$ 109,946  | \$ 19,501  |
| Federal Home Loan Bank and other<br>membership bank stocks | 15,797            | 15,797        |  | 15,797  |  |
| Loans and leases, net                                      | 3,420,715         | 3,439,536     |  |   | 3,439,536  |
| <b>Financial Instruments - Liabilities:</b>                |                   |               |  |   |  |
| Certificates of deposit                                    | 477,336           | 478,596       |  | 478,596   |  |
| Other borrowings   | 294,771           | 300,956       |  | 300,956   |  |
| Subordinated debentures                                    | 31,238            | 21,242        |  |   | 21,242   |
| <b>December 31, 2015</b>                                   |                   |               |  |   |  |
| <b>Financial Instruments - Assets:</b>                     |                   |               |  |   |  |
| Investment securities held to maturity                     | \$ 116,740        | \$ 117,594    | \$   | \$ 110,293  | \$ 7,301   |
| Federal Home Loan Bank and other<br>membership bank stocks | 14,087            | 14,087        |  | 14,087  |  |
| Loans and leases, net                                      | 2,934,326         | 2,930,188     |  |   | 2,930,188  |
| <b>Financial Instruments - Liabilities:</b>                |                   |               |  |   |  |
| Certificates of deposit                                    | 343,321           | 341,998       |  | 341,998   |  |
| Other borrowings   | 271,905           | 275,409       |  | 275,409   |  |
| Subordinated debentures                                    | 31,238            | 24,366        |  |   | 24,366   |



**Table of Contents****Note 12. Statement of Cash Flow Information, Supplemental Information**

|   | For the six months ended June 30, |          |
|---|-----------------------------------|----------|
|   | 2016                              | 2015     |
|   | (in thousands)                    |          |
| Supplemental schedule of noncash investing and financing activities:                            |                                   |          |
| Cash paid during the period for income taxes  | \$ 10,682                         | \$ 7,645 |
| Cash paid during the period for interest  | 7,501                             | 5,016    |
| Transfer of loans and leases into other repossessed assets and other real estate owned          | 1,280                             | 760      |
| Acquisition of Pascack:   |                                   |          |
| Non-cash assets acquired:   |                                   |          |
| Federal Home Loan Bank stock  | 2,962                             |          |
| Investment securities held for maturity   | 3,925                             |          |
| Loans, including loans held for sale  | 319,575                           |          |
| Goodwill and other intangible assets, net   | 16,825                            |          |
| Other assets  | 21,110                            |          |
| Total non-cash assets acquired  | 364,397                           |          |
| Liabilities assumed:  |                                   |          |
| Deposits  | (304,466)                         |          |
| Other borrowings  | (57,308)                          |          |
| Other liabilities   | (6,344)                           |          |
| Total liabilities assumed   | (368,118)                         |          |
| Common stock issued and fair value of stock options converted to Lakeland Bancorp stock options | 37,221                            |          |

**Note 13. Recent Accounting Pronouncements**

In June 2016, the Financial Accounting Standards Board ( FASB ) issued an accounting standards update pertaining to the measurement of credit losses on financial instruments. This update requires the measurement of all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions, and reasonable and supportable financials. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. This update is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. This update will be effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2019. The Company is currently assessing the impact that the guidance will have on the Company's consolidated financial statements.

In March 2016, the FASB issued an accounting standards update to simplify employee share-based payment accounting. The areas for simplification in this update involve several aspects of the accounting for employee share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This update will be effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2017. The Company is currently assessing the impact that the guidance will have on the Company's consolidated financial statements.

In March, 2016, the FASB issued an accounting standards update that requires that embedded derivatives be separated from the host contract and accounted for separately as derivatives if certain criteria are met, including the clearly and closely related criterion. The amendments in this update clarify the requirements for assessing whether contingent call or put options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. This update

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will be effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2016. This guidance will be applied on a modified retrospective basis as of the beginning of the fiscal year that the amendment is effective. The adoption of this update is not expected to have a material impact on the Company's financial statements.

In February 2016, FASB issued accounting guidance that requires all lessees to recognize a lease liability and a right-of-use asset, measured at the present value of the future minimum lease payments, at the lease commencement date. Lessor accounting remains largely unchanged under the new guidance. The guidance is effective for fiscal years beginning after December 15, 2018, including interim reporting periods within that reporting period, with early adoption permitted. A modified retrospective approach must be applied for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company is currently assessing the impact that the guidance will have on the Company's consolidated financial statements.

In January 2016, the FASB issued an accounting standards update intended to improve the recognition and measurement of financial instruments. Specifically, the accounting standards update requires all equity instruments, with the exception of those that are accounted for under the equity method of accounting, to be measured at fair value with changes in the fair value recognized through net income. Additionally, public business entities are required to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. The amendments in this update also require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. This amendment is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The adoption of this update is not expected to have a material impact on the Company's financial statements.

In September 2015, the FASB issued an accounting standards update simplifying the accounting for adjustments made to provisional amounts recognized in a business combination, eliminating the requirement to retrospectively account for those adjustments. To simplify the accounting for adjustments made to provisional amounts, the amendments in the accounting standards update require that the acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amount is determined. The acquirer is required to also record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. In addition, an entity is required to present separately on the face of the income statement or disclose in the notes to the financial statements the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. This amendment is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of this update did not have a material impact on the Company's financial statements.

In May 2015, the FASB issued an accounting standards update clarifying how investments valued using the net asset value practical expedient within the fair value hierarchy should be classified. The accounting standards update was issued to address diversity in practice by exempting investments measured using the net asset value expedient from categorization in the fair value hierarchy. This accounting standards update is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of this update did not have a material impact on the Company's financial statements.

In April 2015, the FASB issued an accounting standards update requiring that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability consistent with the presentation of debt discounts. The purpose of this update is to simplify the presentation of

debt issuance costs and to align the U.S. GAAP presentation of debt more closely with international accounting standards. In August 2015, the FASB issued a subsequent update which discussed presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements. These amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of these updates did not have a material impact on the Company's financial statements.

In January 2015, the FASB issued an accounting standards update regarding the elimination of the concept of the extraordinary items from the statement of operations. The purpose of this update is to simplify the statement of operations presentation and to align the U.S. GAAP income statement more closely with international accounting standards. This update is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of this update did not have a material impact on the Company's financial statements.

In May 2014, the FASB issued an accounting standards update that clarifies the principles for recognizing revenue. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to a

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customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for these goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the entity satisfies a performance obligation. In 2016, the FASB issued further implementation guidance regarding revenue recognition. This additional guidance included clarification on certain principal versus agent considerations within the implementation of the guidance as well as clarification related to identifying performance obligations and licensing. The guidance along with its updates is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The Company is still evaluating the potential impact on the Company's financial statements.

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### **ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This section should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

#### **Statements Regarding Forward Looking Information**

The information disclosed in this document includes various forward-looking statements that are made in reliance upon the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 with respect to credit quality (including delinquency trends and the allowance for loan and lease losses), corporate objectives, and other financial and business matters. The words anticipates, projects, intends, estimates, expects, believes, plans, may, could, and other similar expressions are intended to identify such forward-looking statements. The Company cautions that these forward-looking statements are necessarily speculative and speak only as of the date made, and are subject to numerous assumptions, risks and uncertainties, all of which may change over time. Actual results could differ materially from such forward-looking statements.

In addition to the risk factors disclosed elsewhere in this document, the following factors, among others, could cause the Company's actual results to differ materially and adversely from such forward-looking statements: changes in the financial services industry and the U.S. and global capital markets, changes in economic conditions nationally, regionally and in the Company's markets, the nature and timing of actions of the Federal Reserve Board and other regulators, the nature and timing of legislation affecting the financial services industry including but not limited to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, government intervention in the U.S. financial system, changes in levels of market interest rates, pricing pressures on loan and deposit products, credit risks of Lakeland's lending and leasing activities, customers' acceptance of Lakeland's products and services, competition, and the failure to realize anticipated efficiencies and synergies following the Pascack and Harmony mergers.

The above-listed risk factors are not necessarily exhaustive, particularly as to possible future events, and new risk factors may emerge from time to time. Certain events may occur that could cause the Company's actual results to be materially different than those described in the Company's periodic filings with the Securities and Exchange Commission. Any statements made by the Company that are not historical facts should be considered to be forward-looking statements. The Company is not obligated to update and does not undertake to update any of its forward-looking statements made herein.

#### **Critical Accounting Policies, Judgments and Estimates**

The accounting and reporting policies of the Company and its subsidiaries conform to accounting principles generally accepted in the United States of America and predominant practices within the banking industry. The consolidated financial statements include the accounts of the Company, Lakeland, Lakeland NJ Investment Corp., Lakeland Investment Corp., Lakeland Equity, Inc., Lakeland Preferred Equity, Inc., and Sullivan Financial Services, Inc. All intercompany balances and transactions have been eliminated.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. These estimates and assumptions also affect reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. There have been no material changes in the Company's critical accounting policies, judgments and estimates, including assumptions or estimation techniques utilized, as compared to those disclosed in the Company's most recent Annual Report on Form 10-K.



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**Management Overview**

The quarter and six months ended June 30, 2016 represented a period of continued growth for the Company. As discussed in this Management's Discussion and Analysis:

Net income in the second quarter of 2016 was \$10.1 million, 29% higher than the \$7.9 million for the same period in 2015. Excluding the after-tax impact of \$0.6 million in merger related expenses pertaining to the Company's acquisitions of Pascack Bancorp, Inc. ( "Pascack" ), which closed on January 7, 2016, and Harmony Bank ( "Harmony" ), which closed on July 1, 2016, net income for the second quarter of 2016 was \$10.7 million.

Earnings per diluted share was \$0.24 in the second quarter of 2016, 14% higher than the \$0.21 per diluted share reported in the second quarter of 2015. Excluding merger related expenses, earnings per diluted share was \$0.26 in the second quarter of 2016, a 24% increase over the same period in 2015. Please see "Non-GAAP Financial Measures" below for a reconciliation of EPS excluding merger related expenses.

Net income for the first six months of 2016 was \$18.2 million, or \$0.44 per diluted share, compared to \$16.2 million, or \$0.42 per diluted share, for the same period in 2015. Excluding the after-tax impact of \$1.7 million in merger related expenses, net income for the first six months of 2016 was \$20.0 million, or \$0.48 per diluted share.

The annualized return on average assets for the six months ended June 30, 2016 was 0.85%, the annualized return on average common equity was 8.23%, and the annualized return on average tangible common equity was 11.53%. Excluding merger related expenses, these ratios were 0.93%, 9.00% and 12.62%, respectively.

Net interest margin ( "NIM" ) was 3.47% for the second quarter of 2016, compared to 3.48% for the first quarter of 2016 and 3.46% for the second quarter of 2015.

The Company reported strong loan growth for the first six months of 2016. For the first six months of 2016, total loans and leases increased by \$486.4 million, or 16%, to \$3.45 billion. This increase was \$166.8 million, or 6%, after excluding the \$319.6 million in loans acquired from Pascack.

The Company also reported strong deposit growth for the first six months of 2016. Total deposits have increased \$541.8 million, or 18%, since December 31, 2015. This increase was \$237.3 million, or 8%, after excluding the \$304.5 million in deposits acquired from Pascack. Noninterest bearing deposits increased \$130.3 million, or 19%, in 2016. This increase was \$65.9 million, or 9%, after excluding the \$64.4 million in deposits acquired from Pascack.



On January 7, 2016, the Company completed its acquisition of Pascack which added \$405.5 million in total assets, \$319.6 million in total loans and \$304.5 million in total deposits. The Company recorded goodwill of \$15.3 million and core deposit intangible of \$1.5 million. Anticipated synergies and overlapping markets allowed the Company to close three branches during the first half of 2016. The Company's financial statements reflect the impact of the merger from the date of acquisition, which should be considered when comparing periods. For more information, please see Note 2 in Notes to the Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

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**Comparison of Operating Results for the Three Months Ended June 30, 2016 and 2015**

**Net Income**

Net income was \$10.1 million in the second quarter of 2016 compared to net income of \$7.9 million for the second quarter of 2015. Diluted earnings per share was \$0.24 for the second quarter of 2016, compared to diluted earnings per share of \$0.21 for the same period last year. Excluding the impact of merger related expenses, net income would have been \$10.7 million, or \$0.26 per diluted share, in the second quarter of 2016. Net interest income at \$35.1 million for the second quarter of 2016 increased \$6.4 million from the second quarter of 2015 due primarily to a \$7.7 million increase in interest income, offset by an increase of \$1.3 million in interest expense. The increase in interest income reflects an increase in interest earning assets resulting primarily from the Pascack acquisition as well as organic growth.

**Net Interest Income**

Net interest income is the difference between interest income on earning assets and the cost of funds supporting those assets. The Company's net interest income is determined by: (i) the volume of interest-earning assets that it holds and the yields that it earns on those assets, and (ii) the volume of interest-bearing liabilities that it has assumed and the rates that it pays on those liabilities.

Net interest income on a tax equivalent basis for the second quarter of 2016 was \$35.3 million, compared to \$28.9 million for the second quarter of 2015. The net interest margin increased from 3.46% in the second quarter of 2015 to 3.47% in the second quarter of 2016 primarily as a result of a seven basis point increase in the yield on earning assets, partially offset by an eight basis point increase in the yield on interest bearing liabilities. The increase in the net interest margin was augmented by an increase in interest income earned on free funds (interest earning assets funded by noninterest bearing liabilities) resulting from an increase in average noninterest bearing deposits of \$112.6 million. The components of net interest income will be discussed in greater detail below.

The following table reflects the components of the Company's net interest income, setting forth for the periods presented, (1) average assets, liabilities and stockholders' equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) the Company's net interest spread (i.e., the average yield on interest-earning assets less the average cost of interest-bearing liabilities) and (5) the Company's net interest margin. Rates are computed on a tax equivalent basis using a tax rate of 35%.

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|  | For the Three Months Ended,<br>June 30, 2016 |                                |   | For the Three Months Ended,<br>June 30, 2015 |                                |                                     |
|--|--|--------------------------------|---|--|--------------------------------|-------------------------------------|
|  | Average<br>Balance                           | Interest<br>Income/<br>Expense | Average<br>Rates<br>Earned/<br>Paid<br>(dollars in thousands) | Average<br>Balance                           | Interest<br>Income/<br>Expense | Average<br>Rates<br>Earned/<br>Paid |
| <b>Assets</b>  |  |                                |   |  |                                |                                     |
| Interest-earning assets:                             |  |                                |   |  |                                |                                     |
| Loans and leases (A)                                 | \$ 3,412,503                                 | \$ 35,800                      | 4.22%   | \$ 2,720,801                                 | \$ 28,211                      | 4.16%                               |
| Taxable investment securities and other              | 493,688                                      | 2,696                          | 2.18%   | 532,150                                      | 2,688                          | 2.02%                               |
| Tax-exempt securities                                | 81,518                                       | 642                            | 3.15%   | 68,397                                       | 612                            | 3.58%                               |
| Federal funds sold (B)                               | 106,866                                      | 124                            | 0.46%   | 24,032                                       | 11                             | 0.18%                               |
| Total interest-earning assets                        | 4,094,575                                    | 39,262                         | 3.85%   | 3,345,380                                    | 31,522                         | 3.78%                               |
| Noninterest-earning assets:                          |  |                                |   |  |                                |                                     |
| Allowance for loan and lease losses                  | (30,898)                                     |                                |   | (30,996)                                     |                                |                                     |
| Other assets   | 339,912                                      |                                |   | 286,032                                      |                                |                                     |
| <b>TOTAL ASSETS</b>                                  | <b>\$ 4,403,589</b>                          |                                |   | <b>\$ 3,600,416</b>                          |                                |                                     |
| <b>Liabilities and Stockholders Equity</b>           |  |                                |   |  |                                |                                     |
| Interest-bearing liabilities:                        |  |                                |   |  |                                |                                     |
| Savings accounts                                     | \$ 485,580                                   | \$ 64                          | 0.05%   | \$ 402,142                                   | \$ 53                          | 0.05%                               |
| Interest-bearing transaction accounts                | 1,775,129                                    | 1,376                          | 0.31%   | 1,480,866                                    | 853                            | 0.23%                               |
| Time deposits  | 487,169                                      | 964                            | 0.79%   | 295,996                                      | 440                            | 0.59%                               |
| Borrowings   | 377,937                                      | 1,531                          | 1.62%   | 326,859                                      | 1,293                          | 1.58%                               |
| Total interest-bearing liabilities                   | 3,125,815                                    | 3,935                          | 0.50%   | 2,505,863                                    | 2,639                          | 0.42%                               |
| Noninterest-bearing liabilities:                     |  |                                |   |  |                                |                                     |
| Demand deposits                                      | 801,488                                      |                                |   | 688,854                                      |                                |                                     |
| Other liabilities                                    | 25,480                                       |                                |   | 15,548                                       |                                |                                     |
| Stockholders equity                                  | 450,806                                      |                                |   | 390,151                                      |                                |                                     |
| <b>TOTAL LIABILITIES AND<br/>STOCKHOLDERS EQUITY</b> | <b>\$ 4,403,589</b>                          |                                |   | <b>\$ 3,600,416</b>                          |                                |                                     |
| Net interest income/spread                           |  | 35,327                         | 3.35%   |  | 28,883                         | 3.36%                               |
| Tax equivalent basis adjustment                      |  | 225                            |   |  | 214                            |                                     |
| <b>NET INTEREST INCOME</b>                           |  | <b>\$ 35,102</b>               |   |  | <b>\$ 28,669</b>               |                                     |
| Net interest margin (C)                              |  |                                | 3.47%   |  |                                | 3.46%                               |

- (A) Includes non-accrual loans, the effect of which is to reduce the yield earned on loans, and deferred loan fees.
- (B) Includes interest-bearing cash accounts.
- (C) Net interest income divided by interest-earning assets.

Interest income on a tax equivalent basis increased from \$31.5 million in the second quarter of 2015 to \$39.3 million in the second quarter of 2016, an increase of \$7.7 million, or 25%. The increase in interest income was primarily a result of the Pascack acquisition and organic growth in loans, as average loans and leases increased \$691.7 million compared to the second quarter of 2015. The yield on average loans and leases at 4.22% in the second quarter of 2016 was six basis points higher than the second quarter of 2015, due primarily to a \$367,000 increase in loan and lease prepayment fees. The yield on average taxable investment securities increased 16 basis points, while the yield on tax-exempt investment securities decreased by 43 basis points, compared to the second quarter of 2015. The income on taxable securities included \$101,000 in income from calls on U.S. Government Agency securities. The decrease in yield on tax-exempt investment securities was primarily due to maturing securities at higher rates and new purchases at lower rates.

Total interest expense of \$3.9 million in the second quarter of 2016 was \$1.3 million greater than the \$2.6 million reported for the same period in 2015. The cost of average interest-bearing liabilities increased from 0.42% in the second quarter of 2015 to 0.50% in 2016. The increase in the yield on interest-bearing deposits was due primarily to higher costing

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deposits acquired in the Pascack acquisition as well as an increasingly competitive market for deposits. The yield on interest-bearing transaction accounts and time deposits increased by eight basis points and 20 basis points, respectively. Time deposits, which pay a higher interest rate than interest-bearing transaction accounts, increased from 12% of interest-bearing liabilities in the second quarter of 2015 to 16% in the second quarter of 2016, impacting the increase in the Company's cost of interest-bearing liabilities. Also impacting the cost of interest-bearing liabilities was an increase in the cost of borrowings which increased four basis points compared to the second quarter of 2015. As loan growth exceeded growth in core deposits from the second quarter of 2015 to the same period in 2016, the Company utilized higher cost time deposits and term borrowings from the Federal Home Loan Bank of New York to fund loan growth.

**Provision for Loan and Lease Losses**

In determining the provision for loan and lease losses, management considers national and local economic conditions; trends in the portfolio including orientation to specific loan types or industries; experience, ability and depth of lending management in relation to the complexity of the portfolio; adequacy and adherence to policies, procedures and practices; levels and trends in delinquencies, impaired loans and net charge-offs; and the results of independent third party loan review.

In the second quarter of 2016, a \$1.0 million provision for loan and lease losses was recorded, which was \$270,000, or 36%, higher than the provision for the same period last year. During the second quarter of 2016, the Company charged off loans and leases of \$1.0 million and recovered \$149,000 in previously charged off loans and leases compared to \$1.5 million and \$404,000, respectively, during the same period in 2015. The higher provision resulted primarily from increasing trends in non-performing loans. For more information regarding the determination of the provision, see Risk Elements below.

**Noninterest Income**

Noninterest income at \$4.9 million in the second quarter of 2016 decreased by \$73,000 compared to \$5.0 million in the second quarter of 2015. Commissions and fees at \$1.1 million in the second quarter of 2016 decreased \$97,000 compared to the same period last year, due primarily to a decrease in investment commission income resulting from a decrease in demand for annuities. Gains on sales of loans totaled \$425,000 in the second quarter of 2016 compared to \$464,000 during the same period last year, due to decreased sales of residential mortgages. Income on bank owned life insurance of \$414,000 for the second quarter of 2016 increased \$26,000 or 7% compared to the same period last year, due primarily to the addition of new policies late in 2015.

**Noninterest Expense**

Noninterest expense in the second quarter of 2016 totaled \$23.7 million, which was \$2.5 million greater than the \$21.2 million reported for the second quarter of 2015. Included in noninterest expense during the second quarter of 2016 was \$685,000 in merger related expenses. Excluding merger related expenses, total noninterest expense would have been \$23.0 million, a \$1.8 million increase compared to the second quarter of 2015. Salaries and employee benefits expense at \$13.1 million, increased \$947,000 from the same period last year, primarily due to a full quarter of expenses associated with the loan production offices that opened in 2015, the addition of Pascack employees during the first quarter of 2016 and year-over-year increases in employee salary and benefit costs. Net occupancy expense, telecommunications expense and furniture and equipment increased \$68,000, \$28,000 and \$453,000, respectively, compared to the second quarter of 2015, due primarily to the addition of the Pascack branches. Stationary, supplies and postage at \$416,000 in the second quarter of 2016 was \$39,000 greater than the same period last year, due primarily to mailings and supplies associated with the Pascack merger. Marketing expense of \$385,000 in the second

quarter of 2016 decreased \$31,000 compared to the second quarter of 2015, due primarily to the timing of marketing campaigns. FDIC insurance expense of \$681,000 in the second quarter of 2016 increased \$150,000 compared to the same period last year, due to the addition of the Pascack deposits. The Company's efficiency ratio, a non-GAAP financial measure, was 56.23% in the second quarter of 2016, compared to 62.09% for the same period last year. The decrease in this ratio reflects the realization of cost savings from the Pascack acquisition, including the closing of three branches. The Company uses this ratio because it believes that the ratio provides a good

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comparison of period-to-period performance and because the ratio is widely accepted in the banking industry. The following table shows the calculation of the efficiency ratio for the periods presented:

|   | For the Three Months Ended June 30, |           |
|---|-------------------------------------|-----------|
|   | 2016                                | 2015      |
|   | (dollars in thousands)              |           |
| <b>Calculation of Efficiency Ratio</b>                      |                                     |           |
| Total noninterest expense                                   | \$ 23,715                           | \$ 21,195 |
| Amortization of core deposit intangibles                    | (164)                               | (107)     |
| Other real estate owned and other repossessed asset expense | (26)                                | (27)      |
| Merger related expenses                                     | (685)                               |           |
| Provision for unfunded lending commitments                  | (230)                               | (60)      |
| Noninterest expense, as adjusted                            | \$ 22,610                           | \$ 21,001 |
| Net interest income   | \$ 35,102                           | \$ 28,669 |
| Noninterest income  | 4,885                               | 4,958     |
| Total revenue   | 39,987                              | 33,627    |
| Tax-equivalent adjustment on municipal securities           | 225                                 | 214       |
| Less:   |                                     |           |
| Gains on sales of investment securities                     |                                     | (17)      |
| Total revenue, as adjusted                                  | \$ 40,212                           | \$ 33,824 |
| Efficiency ratio  | 56.2%                               | 62.1%     |

**Income Tax Expense**

The effective tax rate increased from 32.8% in the second quarter of 2015 to 33.6% in the second quarter of 2016 primarily as a result of a decrease in tax advantaged items as a percent of pretax income. Tax advantaged items include tax-exempt security interest and income on bank owned life insurance policies. Also contributing to the increase in the effective tax rate was the impact of non-deductible merger related expenses.

**Comparison of Operating Results for the Six Months Ended June 30, 2016 and 2015****Net Income**

Net income was \$18.2 million in the first half of 2016 compared to net income of \$16.2 million for the first half of 2015. Diluted earnings per share was \$0.44 for the first half of 2016, compared to diluted earnings per share of \$0.42 for the same period last year. Excluding the impact of merger related expenses, net income for the first six months of 2016 was \$20.0 million, or \$0.48 per diluted share. Net interest income at \$69.0 million for the first half of 2016 increased \$11.8 million compared to the first half of 2015 due to a \$14.3 million increase in interest income partially offset by a \$2.5 million increase in interest expense. The increase in interest income reflects an increase in interest earning assets resulting primarily from the Pascack acquisition as well as organic growth.

## **Net Interest Income**

Net interest income on a tax equivalent basis for the first half of 2016 was \$69.4 million, compared to \$57.6 million for the first half of 2015 resulting primarily from growth in average earning assets of \$705.4 million. The net interest margin decreased from 3.51% in the first half of 2015 to 3.48% in the first half of 2016 primarily as a result of a nine basis point increase in the cost of interest bearing liabilities primarily due to an increasingly competitive market for deposits as well as higher costing core deposits acquired in the Pascack acquisition. The decrease in the net interest margin was somewhat mitigated by an increase in interest income earned on free funds (interest earning assets funded by noninterest bearing liabilities) resulting from an increase in average noninterest bearing deposits of \$106.1 million. The components of net interest income will be discussed in greater detail below.



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The following table reflects the components of the Company's net interest income, setting forth for the periods presented, (1) average assets, liabilities and stockholders' equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) the Company's net interest spread (i.e., the average yield on interest-earning assets less the average cost of interest-bearing liabilities) and (5) the Company's net interest margin. Rates are computed on a tax equivalent basis using a tax rate of 35%.

|   | For the Six Months Ended,<br>June 30, 2016 |                                |   | For the Six Months Ended,<br>June 30, 2015 |                                |                                     |
|---|--|--------------------------------|---|--|--------------------------------|-------------------------------------|
|   | Average<br>Balance                         | Interest<br>Income/<br>Expense | Average<br>Rates<br>Earned/<br>Paid<br>(dollars in thousands) | Average<br>Balance                         | Interest<br>Income/<br>Expense | Average<br>Rates<br>Earned/<br>Paid |
| <b>Assets</b>   |  |                                |   |  |                                |                                     |
| Interest-earning assets:                              |  |                                |   |  |                                |                                     |
| Loans (A)   | \$ 3,348,421                               | \$ 69,921                      | 4.20%   | \$ 2,690,823                               | \$ 56,107                      | 4.20%                               |
| Taxable investment securities and other               | 494,788                                    | 5,658                          | 2.29%   | 523,179                                    | 5,362                          | 2.05%                               |
| Tax-exempt securities                                 | 78,106                                     | 1,277                          | 3.27%   | 68,599                                     | 1,243                          | 3.62%                               |
| Federal funds sold (B)                                | 92,553                                     | 199                            | 0.43%   | 25,849                                     | 23                             | 0.18%                               |
| Total interest-earning assets                         | 4,013,868                                  | 77,055                         | 3.86%   | 3,308,450                                  | 62,735                         | 3.82%                               |
| Noninterest-earning assets:                           |  |                                |   |  |                                |                                     |
| Allowance for loan and lease losses                   | (31,013)                                   |                                |   | (30,994)                                   |                                |                                     |
| Other assets  | 343,175                                    |                                |   | 286,404                                    |                                |                                     |
| <b>TOTAL ASSETS</b>                                   | <b>\$ 4,326,030</b>                        |                                |   | <b>\$ 3,563,860</b>                        |                                |                                     |
| <b>Liabilities and Stockholders' Equity</b>           |  |                                |   |  |                                |                                     |
| Interest-bearing liabilities:                         |  |                                |   |  |                                |                                     |
| Savings accounts                                      | \$ 480,725                                 | \$ 157                         | 0.07%   | \$ 398,667                                 | \$ 104                         | 0.05%                               |
| Interest-bearing transaction accounts                 | 1,728,855                                  | 2,624                          | 0.31%   | 1,488,028                                  | 1,692                          | 0.23%                               |
| Time deposits   | 476,097                                    | 1,828                          | 0.77%   | 288,459                                    | 833                            | 0.58%                               |
| Borrowings  | 388,680                                    | 3,047                          | 1.57%   | 311,089                                    | 2,484                          | 1.60%                               |
| Total interest-bearing liabilities                    | 3,074,357                                  | 7,656                          | 0.50%   | 2,486,243                                  | 5,113                          | 0.41%                               |
| Noninterest-bearing liabilities:                      |  |                                |   |  |                                |                                     |
| Demand deposits                                       | 780,843                                    |                                |   | 674,780                                    |                                |                                     |
| Other liabilities                                     | 25,015                                     |                                |   | 15,950                                     |                                |                                     |
| Stockholders' equity                                  | 445,815                                    |                                |   | 386,887                                    |                                |                                     |
| <b>TOTAL LIABILITIES AND<br/>STOCKHOLDERS' EQUITY</b> | <b>\$ 4,326,030</b>                        |                                |   | <b>\$ 3,563,860</b>                        |                                |                                     |

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|                                 |           |       |           |       |
|---------------------------------|-----------|-------|-----------|-------|
| Net interest income/spread      | 69,399    | 3.36% | 57,622    | 3.41% |
| Tax equivalent basis adjustment | 447       |       | 435       |       |
| NET INTEREST INCOME             | \$ 68,952 |       | \$ 57,187 |       |
| Net interest margin (C)         |           | 3.48% |           | 3.51% |

(A) Includes non-accrual loans, the effect of which is to reduce the yield earned on loans, and deferred loan fees.

(B) Includes interest-bearing cash accounts.

(C) Net interest income divided by interest-earning assets.

Interest income on a tax equivalent basis increased from \$62.7 million in the first half of 2015 to \$77.1 million in the first half of 2016, an increase of \$14.3 million, or 23%. The increase in interest income was primarily a result of the Pascack acquisition and organic growth in loans, as the average balance of loans and leases increased \$657.6 million compared to the first half of 2015. The yield on average loans and leases of 4.20% in the first half of 2016 equaled the first half of 2015. The yield on average taxable investment securities increased 24 basis points, while the yield on tax-exempt investment securities decreased by 35 basis points, compared to the first half of 2015. Interest on taxable investment securities included \$358,000 in income on called U.S. Government Agency securities. The decrease in yield on tax-exempt investment securities was due to the same reasons discussed in the quarterly comparison.

Total interest expense increased from \$5.1 million in the first half of 2015 to \$7.7 million in the first half of 2016, an increase of \$2.5 million, or 50%. The cost of average interest-bearing liabilities increased from 0.41% in the first half of 2015 to 0.50% in 2016. The yield on interest-bearing transaction accounts and time deposits increased by eight basis points

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and 19 basis points, respectively. The increase in the yield on interest-bearing deposits was due primarily to higher costing deposits acquired in the Pascack acquisition as well as an increasingly competitive market for deposits. As growth in loans exceeded growth in core deposits from the first half of 2015 to the first half of 2016, the Company utilized higher cost time deposits and term borrowings from the Federal Home Loan Bank of New York to fund loan growth.

### **Provision for Loan and Lease Losses**

In the first half of 2016, a \$2.1 million provision for loan and lease losses was recorded, which was \$475,000 greater than the provision for the same period last year. During the first half of 2016, the Company charged off loans and leases of \$2.6 million and recovered \$296,000 in previously charged off loans and leases compared to \$2.8 million and \$636,000, respectively, during the same period in 2015. The increased provision primarily resulted from higher net charge-offs during the six months ended June 30, 2016, as well as an increasing trend in non-performing loans from June 30, 2015 to June 30, 2016. For more information regarding the determination of the provision, see Risk Elements below.

### **Noninterest Income**

Noninterest income of \$9.8 million in the first half of 2016 increased by \$56,000 compared to the first half of 2015. Service charges on deposit accounts of \$5.0 million in the first half of 2016 increased \$175,000, or 4%, while commissions and fees of \$2.1 million in the first half of 2016 decreased \$425,000 compared to the same period last year due primarily to the same reason discussed in the quarterly analysis. Gains on sales of loans of \$845,000 and gain on investment securities of \$370,000 in the first half of 2016 increased \$116,000 and \$353,000, respectively, compared to the same period last year. In the first half of 2015, a \$332,000 death benefit was received on a bank owned life insurance policy, accounting for the 24% decrease in that category. Other income totaling \$672,000 in the first half of 2016 was \$102,000 higher than the same period in 2015 as swap income increased \$173,000 while gains on sale of other real estate decreased \$78,000 compared to the first half of 2015.

### **Noninterest Expense**

Noninterest expense totaling \$49.1 million increased \$7.9 million in the first half of 2016 from the first half of 2015. Included in noninterest expense during the first half of 2016 was \$2.4 million in merger related expenses. Excluding merger related expenses, total noninterest expense would have been \$46.7 million, a \$5.5 million increase compared to the first half of 2015. Salary and employee benefits of \$27.2 million increased by \$3.3 million, or 14%, due primarily to the addition of the Pascack employees as well as normal salary and benefit increases. Net occupancy expense, telecommunications expense and furniture and equipment increased \$208,000, \$107,000 and \$743,000, respectively, compared to the first half of 2015 due to the addition of the Pascack branches. Stationary, supplies and postage increased \$117,000 compared to the first half of 2015 primarily due to the same reason discussed in the quarterly comparison. Marketing expense of \$694,000 in the first half of 2016 increased \$38,000 compared to the first half of 2015 due primarily to the timing of marketing campaigns. FDIC insurance expense of \$1.3 million in the first half of 2016 increased \$222,000 compared to the same period last year, due to the addition of the Pascack deposits. Data processing expense of \$979,000 increased \$206,000, primarily due to increases in the cost of mobile banking and the addition of the Pascack branches. Other expenses of \$4.8 million in the first half of 2016 increased \$410,000 compared to the first half of 2015 as donation expense and courier expense increased \$119,000 and \$167,000, respectively. The increase in courier expense is due to the outsourcing of the Company's couriers which had previously impacted salary expense. The Company's efficiency ratio, a non-GAAP financial measure, was 58.3% in the first half of 2016, compared to 60.6% for the same period last year. The decrease in efficiency ratio was due to the same reason discussed in the quarterly comparison. The Company uses this ratio because it believes that the ratio provides a good

comparison of period-to-period

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performance and because the ratio is widely accepted in the banking industry. The following table shows our calculation of the efficiency ratio for the periods presented:

|   | For the Six Months Ended June 30, |           |
|---|-----------------------------------|-----------|
|   | 2016                              | 2015      |
|   | (dollars in thousands)            |           |
| <b>Calculation of Efficiency Ratio</b>                      |                                   |           |
| Total noninterest expense                                   | \$ 49,139                         | \$ 41,237 |
| Less:   |                                   |           |
| Amortization of core deposit intangibles                    | (331)                             | (218)     |
| Other real estate owned and other repossessed asset expense | (65)                              | (19)      |
| Merger related expenses                                     | (2,406)                           |           |
| Provision for unfunded lending commitments                  | (438)                             | (190)     |
| Noninterest expense, as adjusted                            | \$ 45,899                         | \$ 40,810 |
| Net interest income   | \$ 68,952                         | \$ 57,187 |
| Noninterest income  | 9,752                             | 9,696     |
| Total revenue   | 78,704                            | 66,883    |
| Tax-equivalent adjustment on municipal securities           | 447                               | 435       |
| Less:   |                                   |           |
| Gains on sales of investment securities                     | (370)                             | (17)      |
| Total revenue, as adjusted                                  | \$ 78,781                         | \$ 67,301 |
| Efficiency ratio  | 58.3%                             | 60.6%     |

**Income Tax Expense**

The effective tax rate increased from 32.6% in the first half of 2015 to 33.6% in the first half of 2016 as a result of the same reasons discussed in the quarterly comparison.

**Financial Condition**

The Company's total assets increased \$598.3 million from December 31, 2015, to \$4.47 billion at June 30, 2016 including the impact of Pascack's assets which represented \$405.5 million at the time of acquisition.

**Loans and Leases**

Gross loans and leases of \$3.45 billion increased by \$486.4 million from December 31, 2015 including Pascack loans which totaled \$319.6 million at acquisition. Excluding Pascack's loans, total loans have increased 6% from December 31, 2015, primarily in the commercial loans secured by real estate category. Excluding the impact of the Pascack loans of \$273.7 million, commercial loans secured by real estate increased \$164.8 million, or 9%, from December 31, 2015 to June 30, 2016. Leases also increased \$6.7 million, or 12%, resulting from increased demand for equipment

financing. Excluding the impact of the Pascack loans of \$22.3 million, commercial, industrial and other decreased \$16.3 million, or 5%. Real estate-residential mortgages declined \$16.1 million, or 4%, excluding the impact of Pascack's residential mortgages of \$10.3 million. The decline in residential mortgages results from a decision to sell most of the residential loans that the Company originates. Excluding the impact of Pascack loans totaling \$1.0 million and \$12.2 million, respectively, Real estate construction loans increased \$33.9 million, or 29%, while home equity and consumer loans decreased \$6.2 million. For more information on the loan portfolio, see Note 5 in Notes to the Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

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**Risk Elements**

Non-performing assets increased from \$23.7 million at December 31, 2015 to \$26.5 million at June 30, 2016, primarily in the commercial secured by real estate category which increased by \$2.1 million. Although non-performing assets increased, the percentage of non-performing assets to total assets decreased from 0.61% at December 31, 2015 to 0.59% at June 30, 2016. Non-accrual loans at June 30, 2016 included 5 loan relationships with a balance of \$1.0 million or over, totaling \$7.8 million, and 4 loan relationships between \$500,000 and \$1.0 million, totaling \$2.8 million.

There were \$42,000 in loans and leases past due ninety days or more and still accruing at June 30, 2016 compared to \$331,000 at December 31, 2015. These loans primarily consisted of consumer loans which are generally placed on non-accrual and reviewed for charge-off when principal and interest payments are four months in arrears unless the obligations are well-secured and in the process of collection.

On June 30, 2016, the Company had \$9.5 million in loans that were troubled debt restructurings and accruing interest income compared to \$10.1 million at December 31, 2015. Troubled debt restructurings are those loans where the Company has granted concessions to the borrower in payment terms, either in rate or in term, as a result of the financial condition of the borrower.

On June 30, 2016, the Company had \$27.1 million in impaired loans (consisting primarily of non-accrual and restructured loans and leases) compared to \$26.0 million at year-end 2015. The Company also had purchased credit impaired loans from the Pascack acquisition of \$758,000 at June 30, 2016. For more information on impaired loans and leases see Note 5 in Notes to the Consolidated Financial Statements of this Quarterly Report on Form 10-Q. The valuation allowance for impaired loans is based primarily on the fair value of the underlying collateral. Based on such evaluation, \$670,000 of the allowance for loan and lease losses has been allocated for impairment at June 30, 2016. At June 30, 2016, the Company also had \$43.6 million in loans and leases that were rated substandard that were not classified as non-performing or impaired compared to \$46.6 million at December 31, 2015.

There were no loans and leases at June 30, 2016, other than those designated non-performing, impaired or substandard, where the Company was aware of any credit conditions of any borrowers or obligors that would indicate a strong possibility of the borrowers not complying with present terms and conditions of repayment and which may result in such loans and leases being included as non-accrual, past due or renegotiated at a future date.

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The following table sets forth for the periods presented, the historical relationships among the allowance for loan and lease losses, the provision for loan and lease losses, the amount of loans and leases charged-off and the amount of loan and lease recoveries:

| (dollars in thousands)   | Six Months<br>Ended<br>June 30,<br>2016 | Six Months<br>Ended<br>June 30,<br>2015 | Year<br>Ended<br>December 31,<br>2015 |
|--|---|---|---------------------------------------|
| Balance of the allowance at the beginning of the year                                    | \$ 30,874                               | \$ 30,684                               | \$ 30,684                             |
| Loans and leases charged off:  |   |   |                                       |
| Commercial, secured by real estate   | 274                                     | 1,351                                   | 1,821                                 |
| Commercial, industrial and other   | 796                                     | 74                                      | 205                                   |
| Leases   | 275                                     | 529                                     | 548                                   |
| Real estate - mortgage   | 306                                     | 106                                     | 375                                   |
| Real estate - construction   |   | 20                                      | 20                                    |
| Home equity and consumer   | 937                                     | 676                                     | 1,511                                 |
| Total loans charged off  | 2,588                                   | 2,756                                   | 4,480                                 |
| Recoveries:  |   |   |                                       |
| Commercial, secured by real estate   | 81                                      | 364                                     | 2,221                                 |
| Commercial, industrial and other   | 76                                      | 84                                      | 183                                   |
| Leases   | 22                                      | 20                                      | 26                                    |
| Real estate - mortgage   | 4                                       | 3                                       | 63                                    |
| Real estate - construction   |   | 106                                     | 106                                   |
| Home equity and consumer   | 113                                     | 59                                      | 129                                   |
| Total recoveries   | 296                                     | 636                                     | 2,728                                 |
| Net charge-offs:   | 2,292                                   | 2,120                                   | 1,752                                 |
| Provision for loan and lease losses  | 2,085                                   | 1,610                                   | 1,942                                 |
| Ending balance   | \$ 30,667                               | \$ 30,174                               | \$ 30,874                             |
| Ratio of annualized net charge-offs to average loans and leases outstanding              | 0.14%                                   | 0.16%                                   | 0.06%                                 |
| Ratio of allowance at end of period as a percentage of period end total loans and leases | 0.89%                                   | 1.09%                                   | 1.04%                                 |

The ratio of the allowance for loan and lease losses to loans and leases outstanding reflects management's evaluation of the underlying credit risk inherent in the loan portfolio. The determination of the adequacy of the allowance for loan and lease losses and periodic provisioning for estimated losses included in the consolidated financial statements is the responsibility of management and the Board of Directors. The evaluation process is undertaken on a quarterly basis.



Methodology employed for assessing the adequacy of the allowance consists of the following criteria:

The establishment of specific reserve amounts for all specifically identified classified loans and leases that have been designated as requiring attention by Lakeland.

The establishment of reserves for pools of homogeneous types of loans and leases not subject to specific review, including impaired loans under \$500,000, leases, 1 – 4 family residential mortgages, and consumer loans.

The establishment of reserve amounts for the unimpaired loans and leases in each portfolio based upon the historical average loss experience as modified by management's assessment of the loss emergence period for these portfolios and management's evaluation of key environmental factors.

Consideration is given to the results of ongoing credit quality monitoring processes, the adequacy and expertise of the Company's lending staff, underwriting policies, loss histories, delinquency trends, and the cyclical nature of economic and business conditions. Since many of the Company's loans depend on the sufficiency of collateral as a secondary means of repayment, any adverse trend in the real estate markets could affect underlying values available to protect the Company against loss.

The overall balance of the allowance for loan and lease losses of \$30.7 million at June 30, 2016 decreased \$207,000, from December 31, 2015, a decline of 1%. The change in the allowance within segments of the loan portfolio reflects changes in the non-performing loan and charge-off statistics within each segment as well as the level of growth in each segment. Loan reserves are based on a combination of historical charge-off experience, estimating the appropriate loss emergence and pre-emergence periods and assigning qualitative factors based on general economic conditions and specific bank portfolio characteristics.

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Non-performing loans and leases increased from \$22.7 million at December 31, 2015 to \$24.9 million at June 30, 2016. The allowance for loan and lease losses as a percent of total loans was 0.89% of total loans on June 30, 2016 compared to 1.04% as of December 31, 2015. The reduction in the percentage of the allowance for loan and lease losses as a percent of total loans and leases was primarily due to the \$319.6 million increase in loans resulting from the Pascack acquisition, which is accounted for under acquisition accounting. Excluding the Pascack loans, the allowance as a percent of total loans would be 0.98%. Management believes, based on appraisals and estimated selling costs, that the majority of its non-performing loans and leases are adequately secured and reserves on its non-performing loans and leases are adequate. Based upon the process employed and giving recognition to all accompanying factors related to the loan and lease portfolio, management considers the allowance for loan and lease losses to be adequate at June 30, 2016.

## **Investment Securities**

For detailed information on the composition and maturity distribution of the Company's investment securities portfolio, see Note 4 in Notes to Consolidated Financial Statements contained in this Quarterly Report on Form 10-Q. Total investment securities increased from \$559.1 million at December 31, 2015 to \$586.6 million at June 30, 2016, an increase of \$27.5 million.

## **Deposits**

Total deposits increased from \$3.00 billion at December 31, 2015 to \$3.54 billion at June 30, 2016, an increase of \$541.8 million, or 18%. Pascack's deposits totaled \$304.5 million at the time of acquisition. Noninterest bearing deposits increased \$130.3 million, or 19%, to \$824.1 million. Excluding \$64.4 million in Pascack demand deposits, noninterest bearing demand deposits have increased by \$65.9 million, or 9%, from year-end 2015. Savings and interest-bearing transaction accounts and time deposits increased \$277.4 million and \$134.0 million, respectively. At the time of acquisition, Pascack had savings and interest-bearing transaction accounts and time deposits of \$161.9 million and \$78.1 million, respectively.

## **Liquidity**

Liquidity measures whether an entity has sufficient cash flow to meet its financial obligations and commitments on a timely basis. The Company is liquid when its subsidiary bank has the cash available to meet the borrowing and cash withdrawal requirements of customers and the Company can pay for current and planned expenditures and satisfy its debt obligations.

Lakeland funds loan demand and operation expenses from several sources:

Net income. Cash provided by operating activities was \$11.1 million for the first half of 2016 compared to \$16.1 million for the same period in 2015.

Deposits. Lakeland can offer new products or change its rate structure in order to increase deposits. In the first half of 2016, Lakeland's deposits increased \$237.3 million, excluding the impact of Pascack deposits.

Sales of securities. At June 30, 2016 the Company had \$460.4 million in securities designated available for sale. Of these securities, \$300.7 million were pledged to secure public deposits and for other purposes required by applicable laws and regulations.

Repayments on loans and leases can also be a source of liquidity to fund further loan growth.

Credit lines. As a member of the FHLB, Lakeland has the ability to borrow overnight based on the market value of collateral pledged. Lakeland had no overnight borrowings from the FHLB on June 30, 2016. Lakeland also has overnight federal funds lines available for it to borrow up to \$192.0 million. Lakeland had borrowings against these lines of \$99.6 million at June 30, 2016. Lakeland may also borrow from the discount window of the Federal Reserve Bank of New York based on the market value of collateral pledged. Lakeland had no borrowings with the Federal Reserve Bank of New York as of June 30, 2016.

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Other borrowings. Lakeland can also generate funds by utilizing long-term debt or securities sold under agreements to repurchase that would be collateralized by security or mortgage collateral. At times the market values of securities collateralizing our securities sold under agreements to repurchase may decline due to changes in interest rates and may necessitate our lenders to issue a margin call which requires Lakeland to pledge additional collateral to meet that margin call.

Management and the Board monitor the Company's liquidity through the asset/liability committee, which monitors the Company's compliance with certain regulatory ratios and other various liquidity guidelines.

The cash flow statements for the periods presented provide an indication of the Company's sources and uses of cash, as well as an indication of the ability of the Company to maintain an adequate level of liquidity. A discussion of the cash flow statement for the six months ended June 30, 2016 follows.

Cash and cash equivalents totaling \$152.9 million on June 30, 2016 increased \$34.4 million from December 31, 2015. Operating activities provided \$11.1 million in net cash. Investing activities used \$145.0 million in net cash, primarily reflecting an increase in loans and leases. Financing activities provided \$168.2 million in net cash primarily reflecting the increase in deposits of \$237.6 million offset by declines in federal funds purchased and securities sold under agreements to repurchase of \$27.6 million and net repayments of other borrowings of \$34.1 million. The Company anticipates that it will have sufficient funds available to meet its current loan commitments and deposit maturities. This constitutes a forward-looking statement under the Private Securities Litigation Reform Act of 1995.

The following table sets forth contractual obligations and other commitments representing required and potential cash outflows as of June 30, 2016. Interest on subordinated debentures and long-term borrowed funds is calculated based on current contractual interest rates.

|   |                     | Within              | After One but     | After Three      |                   |
|---|---------------------|---------------------|-------------------|------------------|-------------------|
|   |                     | One Year            | But Within        | But              |                   |
|   |                     |                     | Three             | Within           | After             |
| (dollars in thousands)                                    | Total               |                     | Years             | Five             | Five              |
|   |                     |                     |                   | Years            | Years             |
| Minimum annual rentals on noncancellable operating leases | \$ 30,081           | \$ 2,926            | \$ 5,057          | \$ 4,365         | \$ 17,733         |
| Benefit plan commitments                                  | 6,334               | 250                 | 793               | 793              | 4,498             |
| Remaining contractual maturities of time deposits         | 477,336             | 305,558             | 139,793           | 31,985           |                   |
| Subordinated debentures                                   | 31,238              |                     |                   |                  | 31,238            |
| Loan commitments  | 884,478             | 651,264             | 124,047           | 10,939           | 98,228            |
| Other borrowings  | 294,771             | 111,029             | 168,710           | 5,032            | 10,000            |
| Interest on other borrowings*                             | 28,450              | 6,096               | 5,826             | 3,032            | 13,496            |
| Standby letters of credit                                 | 12,098              | 10,519              | 1,467             | 32               | 80                |
| <b>Total</b>  | <b>\$ 1,764,786</b> | <b>\$ 1,087,642</b> | <b>\$ 445,693</b> | <b>\$ 56,178</b> | <b>\$ 175,273</b> |

\* Includes interest on other borrowings and subordinated debentures at a weighted rate of 2.05%.



**Table of Contents****Capital Resources**

Total stockholders' equity increased from \$400.5 million on December 31, 2015 to \$454.9 million on June 30, 2016, an increase of \$54.4 million, or 14%. Book value per common share increased to \$11.03 on June 30, 2016 from \$10.57 on December 31, 2015. Tangible book value per share increased from \$7.62 per share on December 31, 2015 to \$7.93 per share on June 30, 2016, an increase of 4%. Please see **Non-GAAP Financial Measures** below. The increase in stockholders' equity from December 31, 2015 to June 30, 2016 was primarily due to stock issued of \$37.2 million for the acquisition of Pascack, \$18.2 million of net income and \$5.5 million of other comprehensive income on the Company's available for sale securities portfolio, partially offset by the payment of cash dividends on common stock of \$7.5 million.

The Company and Lakeland are subject to various regulatory capital requirements that are monitored by federal banking agencies. Failure to meet minimum capital requirements can lead to certain supervisory actions by regulators; any supervisory action could have a direct material adverse effect on the Company or Lakeland's financial statements. As of June 30, 2016, the Company and Lakeland met all capital adequacy requirements to which they are subject.

The final rules implementing the Basel Committee on Banking Supervision's (BCBS) capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final rule's requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of June 30, 2016, the Company's capital levels remained characterized as **well-capitalized** under the new rules. The capital ratios for the Company and Lakeland at June 30, 2016 are as follows:

|  | Common Equity   |   |  |   |
|--|---|---|--|---|
|  | Tier 1 Capital<br>to Total Average<br>Assets<br>Ratio<br>June 30,<br>2016 | Tier 1 to<br>Risk-Weighted<br>Assets<br>Ratio<br>June 30,<br>2016 | Tier 1<br>Capital<br>to Risk-Weighted<br>Assets<br>Ratio<br>June 30,<br>2016 | Total<br>Capital<br>to Risk-Weighted<br>Assets<br>Ratio<br>June 30,<br>2016 |
| Capital Ratios   |   |   |  |   |
| The Company  | 8.24%   | 8.91%   | 9.74%  | 10.65%  |
| Lakeland Bank  | 7.93%   | 9.38%   | 9.38%  | 10.30%  |
| Required capital ratios<br>including conservation buffer | 4.00%   | 5.125%  | 6.625%   | 8.625%  |
| Well capitalized institution<br>under FDIC Regulations   | 5.00%   | 6.50%   | 8.00%  | 10.00%  |

**Non-GAAP Financial Measures**

Reported amounts are presented in accordance with U.S. GAAP. The Company's management believes that the supplemental non-GAAP information, which consists of measurements and ratios based on tangible equity and tangible assets, is utilized by regulators and market analysts to evaluate a company's financial condition and therefore, such information is useful to investors. These disclosures should not be viewed as a substitute for financial results determined in accordance with U.S. GAAP, nor are they necessarily comparable to non-GAAP performance measures which may be presented by other companies.



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|   | June 30,<br>2016 | December 31,<br>2015 |
|---|------------------|----------------------|
| (dollars in thousands, except per share amounts)                      |                  |                      |
| <b>Calculation of Tangible Book Value per Common Share</b>            |                  |                      |
| Total common stockholders equity at end of period - GAAP              | \$ 454,934       | \$ 400,516           |
| Less:   |                  |                      |
| Goodwill  | 125,285          | 109,974              |
| Other identifiable intangible assets, net                             | 2,728            | 1,545                |
| Total tangible common stockholders equity at end of period - Non-GAAP | \$ 326,921       | \$ 288,997           |
| Shares outstanding at end of period                                   | 41,241           | 37,906               |
| Book value per share - GAAP   | \$ 11.03         | \$ 10.57             |
| Tangible book value per share - Non-GAAP                              | \$ 7.93          | \$ 7.62              |
| <b>Calculation of Tangible Common Equity to Tangible Assets</b>       |                  |                      |
| Total tangible common stockholders equity at end of period - Non-GAAP | \$ 326,921       | \$ 288,997           |
| Total assets at end of period   | \$ 4,467,860     | \$ 3,869,550         |
| Less:   |                  |                      |
| Goodwill  | 125,285          | 109,974              |
| Other identifiable intangible assets, net                             | 2,728            | 1,545                |
| Total tangible assets at end of period - Non-GAAP                     | \$ 4,339,847     | \$ 3,758,031         |
| Common equity to assets - GAAP  | 10.18%           | 10.35%               |
| Tangible common equity to tangible assets - Non-GAAP                  | 7.53%            | 7.69%                |

|  | For the three months ended,<br>June 30,<br>2016 | June 30,<br>2015 | For the six months ended,<br>June 30,<br>2016 | June 30,<br>2015 |
|--|---|------------------|---|------------------|
| (dollars in thousands)   |   |                  |   |                  |
| <b>Calculation of Return on Average Tangible Common Equity</b> |   |                  |   |                  |
| Net income - GAAP  | \$ 10,130                                       | \$ 7,862         | \$ 18,238                                     | \$ 16,192        |
| Total average common stockholders equity                       | \$ 450,806                                      | \$ 390,151       | \$ 445,815                                    | \$ 386,887       |
| Less:  |   |                  |   |                  |
| Average goodwill   | 125,424   | 109,974          | 124,923                                       | 109,974          |



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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Average other identifiable intangible assets,<br>net                | 2,828      | 1,807      | 2,874      | 1,863      |
| Total average tangible common stockholders<br>equity - Non-GAAP     | \$ 322,554 | \$ 278,370 | \$ 318,018 | \$ 275,050 |
| Return on average common stockholders<br>equity - GAAP              | 9.04%      | 8.08%      | 8.23%      | 8.44%      |
| Return on average tangible common<br>stockholders equity - Non-GAAP | 12.63%     | 11.33%     | 11.53%     | 11.87%     |

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| <b>Reconciliation of Earnings Per Share</b>                                       | <b>For the three<br/>months ended<br/>June 30, 2016</b> | <b>For the six<br/>months ended<br/>June 30, 2016</b> |
|---|---|---|
| <b>excluding non-routine expenses</b><br>(in thousands, except per share amounts) |   |   |
| Net Income:   | \$ 10,130   | \$ 18,238   |
| Non-routine expenses:   |   |   |
| Tax deductible merger related expenses, net of tax                                | 175   | 986   |
| Non-tax deductible merger related expenses  | 389   | 739   |
| Non-routine expenses, net of tax  | \$ 564  | \$ 1,725  |
| Net income available to common shareholders                                       |   |   |
| Excluding merger related expenses   | \$ 10,694   | \$ 19,963   |
| Less: Earnings Allocated to Participating Securities                              | (106)   | (161)   |
|   | \$ 10,588   | \$ 19,802   |
| Weighted Average Shares - Basic   | 41,238  | 41,084  |
| Weighted Average Shares - Diluted   | 41,406  | 41,245  |
| Basic Earnings Per Common Share   | \$ 0.26   | \$ 0.48   |
| Diluted Earnings Per Common Share   | \$ 0.26   | \$ 0.48   |

**ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company manages interest rate risk and market risk by identifying and quantifying interest rate risk exposures using simulation analysis and economic value at risk models. Net interest income simulation considers the relative sensitivities of the balance sheet including the effects of interest rate caps on adjustable rate mortgages and the relatively stable aspects of core deposits. As such, net interest income simulation is designed to address the probability of interest rate changes and the behavioral response of the balance sheet to those changes. Market Value of Portfolio Equity represents the fair value of the net present value of assets, liabilities and off-balance-sheet items. Changes in estimates and assumptions made for interest rate sensitivity modeling could have a significant impact on projected results and conclusions. These assumptions could include prepayment rates, sensitivity of non-maturity deposits and other similar assumptions. Therefore, if our assumptions should change, this technique may not accurately reflect the impact of general interest rate movements on the Company's net interest income or net portfolio value.

The starting point (or base case) for the following table is an estimate of the following year's net interest income assuming that both interest rates and the Company's interest-sensitive assets and liabilities remain at period-end levels. The net interest income estimated for the next twelve months (the base case) is \$136.5 million. The information provided for net interest income assumes that changes in interest rates of plus 200 basis points and minus 200 basis points change gradually in equal increments (rate ramp) over the twelve month period.

|                  | Changes in interest rates |             |
|------------------|---------------------------|-------------|
| <b>Rate Ramp</b> | <b>+200</b>               | <b>-200</b> |
|                  | <b>bp</b>                 | <b>bp</b>   |

|                              |       |       |
|------------------------------|-------|-------|
| Asset/Liability Policy Limit | -5.0% | -5.0% |
| June 30, 2016                | -1.2% | -1.5% |
| December 31, 2015            | -1.4% | -1.6% |

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The Company's review of interest rate risk also includes policy limits for net interest income changes in various rate shock scenarios. Rate shocks assume that current interest rates change immediately. The information provided for net interest income assumes fluctuations or rate shocks for changes in interest rates as shown in the table below.

| <b>Rate Shock</b>            | Changes in interest rates |         |         |         |
|------------------------------|---------------------------|---------|---------|---------|
|                              | +300 bp                   | +200 bp | +100 bp | -100 bp |
| Asset/Liability Policy Limit | -15.0%                    | -10.0%  | -5.0%   | -5.0%   |
| June 30, 2016                | 1.2%                      | 1.1%    | 1.0%    | -3.5%   |
| December 31, 2015            | 1.7%                      | 1.3%    | 0.8%    | -4.5%   |

The base case for the following table is an estimate of the Company's net portfolio value for the periods presented using current discount rates, and assuming the Company's interest-sensitive assets and liabilities remain at period-end levels. The net portfolio value at June 30, 2016 (the base case) was \$574.8 million. The information provided for the net portfolio value assumes fluctuations or rate shocks for changes in interest rates as shown in the table below. Rate shocks assume that current interest rates change immediately.

| <b>Rate Shock</b>            | Changes in interest rates |         |         |         |
|------------------------------|---------------------------|---------|---------|---------|
|                              | +300 bp                   | +200 bp | +100 bp | -100 bp |
| Asset/Liability Policy Limit | -25.0%                    | -20.0%  | -10.0%  | -10.0%  |
| June 30, 2016                | -8.3%                     | -4.7%   | -1.8%   | -3.1%   |
| December 31, 2015            | -10.2%                    | -6.5%   | -2.9%   | 0.3%    |

The information set forth in the above tables is based on significant estimates and assumptions, and constitutes a forward-looking statement under the Private Securities Litigation Reform Act of 1995. For more information regarding the Company's market risk and assumptions used in the Company's simulation models, please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

Certain shortcomings are inherent in the methodologies used in the above interest rate risk measurements. Modeling changes in net interest income requires the making of certain assumptions regarding prepayment and deposit decay rates, which may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. While management believes such assumptions are reasonable, there can be no assurance that assumed prepayment rates and decay rates will approximate actual future loan prepayment and deposit withdrawal activity. Moreover, the net interest income table presented assumes that the composition of interest sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and also assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration to maturity or repricing of specific assets and liabilities. Accordingly, although the net interest income table provides an indication of the Company's interest rate risk exposure at a particular point in time, such measurement is not intended to and does not provide a precise forecast of the effect of changes in market interest rates on net interest income and will differ from actual results.

**ITEM 4. Controls and Procedures**

(a) Disclosure controls and procedures. As of the end of the Company's most recently completed fiscal quarter covered by this report, the Company carried out an evaluation, with the participation of the Company's management, including

the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934, as amended (the Exchange Act). The term disclosure controls and procedures, as defined in Rule 13a-15, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

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Based on the evaluation of the Company's disclosure controls and procedures as of June 30, 2016, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as a result of the material weakness in the Company's internal control over financial reporting previously disclosed in its Annual Report on Form 10-K for the year ended December 31, 2015 (the 2015 10-K), the Company's disclosure controls and procedures were not effective as of June 30, 2016.

As previously disclosed in the Company's 2015 Form 10-K, during the fourth quarter of 2015, management identified a material weakness in internal controls over the completeness and accuracy of the information used to determine the qualitative component of the allowance for loan and lease losses estimate. This material weakness in internal controls occurred due to the control operator not executing the review control, as designed, of the completeness and accuracy of the information used in the qualitative component of the allowance for loan and lease losses estimate as of December 31, 2015. No restatement of prior period financial statements and no change in previously issued financial results were required as a result of this weakness in internal control. Management has taken steps to remediate this weakness by enhancing review controls, including adding an additional independent level of review over the information used to determine the qualitative component in the allowance for loan and lease losses estimation process. Management is still evaluating these new controls and procedures. Once placed in operation for a sufficient period of time, the Company will subject them to appropriate tests in order to determine whether they are operating effectively.

(b) Changes in internal controls over financial reporting. As discussed above, management has continued to remediate the underlying causes of the material weakness disclosed in the 2015 Form 10-K. Other than the plan for remediation described above, there has been no change in the Company's internal control over financial reporting in the quarter ended June 30, 2016 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

Reference is made to the legal proceedings and stipulation of settlement disclosed in the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2016. On June 24, 2016, the court gave final approval to the settlement.

There are no pending legal proceedings involving the Company or Lakeland other than those arising in the normal course of business. Management does not anticipate that the potential liability, if any, arising out of such legal proceedings will have a material effect on the financial condition or results of operations of the Company and Lakeland on a consolidated basis.

**Item 1A. Risk Factors**

There have been no material changes in risk factors from those disclosed under Item 1A, Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

|   |                |
|---|----------------|
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | Not Applicable |
| Item 3. Defaults Upon Senior Securities                             | Not Applicable |
| Item 4. Mine Safety Disclosures                                     | Not Applicable |
| Item 5. Other Information   | Not Applicable |
| Item 6. Exhibits  |                |

|         |   |
|---------|---|
| 31.1    | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                         |
| 31.2    | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                         |
| 32.1    | Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act. |
| 101.INS | XBRL Instance Document  |
| 101.SCH | XBRL Taxonomy Extension Schema Document   |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document   |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document  |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document   |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document  |





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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Lakeland Bancorp, Inc.

(Registrant)

/s/ Thomas J. Shara  
Thomas J. Shara  
President and Chief Executive Officer  
(Principal Executive Officer)

/s/ Joseph F. Hurley  
Joseph F. Hurley  
Executive Vice President and

Chief Financial Officer

(Principal Financial Officer)

Date: August 9, 2016